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In the

Supreme Court of the United States

OCTOBER TERM, 1974

No. 74-1042

ERNST & ERNST,

Petitioner,

vs.

OLGA HOCHFELDER, ET AL.,

Respondents.

ERNST & ERNST,

Petitioner,

vs.

LEON S. MARTIN, ET AL.,

Respondents.

BRIEF FOR RESPONDENTS ALLISON, CARNOVSKY, DRAKE AND JACKSONS

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BRIEF FOR RESPONDENTS ALLISON, CARNOVSKY, DRAKE AND JACKSONS

This brief is filed on behalf of plaintiffs-respondents ("plaintiffs") Helen Allison, Leon N. Carnovsky, Zerah A. Drake, Elizabeth B. Jackson, John M. Jackson, Trustee, and John M. Jackson, Individually. It responds not only to the brief of petitioner Ernst & Ernst ("Ernst & Ernst"), but also to other briefs filed, or sought to be filed, in the case. The Solicitor General, at the invitation of the Court, has filed a brief on behalf of the Securities

and Exchange Commission. The American Institute of Certified Public Accountants ("AICPA") has filed a motion for leave to file a brief amicus. While the Court has not yet acted on this motion, plaintiffs have responded to its brief as well, as it was appended to the motion.

STATUTES AND RULES INVOLVED

In addition to the statute and rule cited by Ernst & Ernst, pp. 2-3, the following statute and rules are relevant:

Section 17(a) of the Securities Exchange Act of 1934, 15 U.S.C. §78q(a):

> SECTION 17. (a) Every national securities exchange, every member thereof, every broker or dealer who transacts a business in securities through the medium of any such member, every registered securities association, and every broker or dealer registered pursuant to section 15 of this title, shall make, keep, and preserve for such periods, such accounts, correspondence, memoranda, papers, books, and other records, and make such reports, as the Commission by its rules and regulations may prescribe as necessary or appropriate in the public interest or for the protection of investors. Such accounts, correspondence, memoranda, papers, books, and other records shall be subject at any time or from time to time to such reasonable periodic, special, or other examinations by examiners or other representatives of the Commission as the Commission may deem necessary or appropriate in the public interest or for the protection of investors.

Rule 17a-5(a)(b), (g), (h) and (i) under the Securities Exchange Act of 1934, 17 C.F.R. §240.17a-5(a), (b), (g), (h) and (i):

Rule 17a-5. Reports To Be Made by Certain Exchange Members, Brokers, and Dealers

(a) Filing Reports. This rule shall apply to every member of a national securities exchange who transacts a business in securities directly with or for others than members of a national securities exchange, every broker or dealer (other than a member) who transacts a business in securities through the medium of any member of a national securities exchange, and every broker or dealer registered pursuant to section 15 of the Act.

Every member, broker or dealer subject to this rule shall file reports of financial condition containing the information required by Form X-17A-5, as follows: (A) a report shall be filed as of a date within each calendar year, except that (i) the first such report of a member, broker or dealer (other than one succeeding to and continuing the business of another member, broker or dealer) shall be as of a date not less than 1 nor more than 5 months after the date on which such member, broker or dealer becomes subject to this rule (in the case of a registered broker or dealer this shall be the date the registration becomes effective) and (ii) a member, broker or dealer succeeding to and continuing the business of another member, broker or dealer need not file a report as of a date in the calendar year in which the succession occurs if the predecessor member, broker or dealer has filed a Form X-17A-5 report in compliance with this rule as of a date in such calendar year; (B) such reports shall be filed not more than 45 days after the date of the report of financial condition; and (C) reports for any 2 consecutive years shall not be as of dates within 4 months of each other. The reports provided for in this rule shall be filed in duplicate original with the Regional Office of the Commission for the region in which the member, broker or dealer has his or its principal place of business.

(b) Nature and Form of Reports. Each report of financial condition filed pursuant to paragraph *(a)* hereof shall be prepared and filed in accordance with the following requirements:

(1) The report of a member, broker or dealer shall be certified by a certified public accountant or a public accountant who shall be in fact independent: *Provided, however,* That such report need not be certified if • • •

[Exceptions to certification requirement omitted as irrelevant.]

(2) Attached to the report shall be an oath or affirmation that, to the best knowledge and belief of the person making such oath or affirmation, (A) the financial statement and supporting schedules are true and correct and (B) neither the member, broker, or dealer, nor any partner, officer, or director, as the case may be, has any proprietary interest in any account classified solely as that of a customer. The oath or affirmation shall be made before a person duly authorized to administer such oaths or affirmations. If the member, broker, or dealer is a sole proprietorship, the oath or affirmation shall be made by the proprietor; if a partnership, by a general partner; or if a corporation, by a duly authorized officer.

[Par. (3) relating to confidentiality of separately bound schedules omitted as irrelevant.]

(g) Accountant's Certificate.

(1) Technical Requirements. The accountant's certificate shall be dated, shall be signed manually, and shall identify without detailed enumeration the items of the report covered by the certificate.

(2) Representations as to Audit. The accountant's certificate (A) shall contain a reasonably comprehensive statement as to the scope of the audit

made, including a statement as to whether the accountant reviewed the procedures followed for safeguarding the securities of customers, and including, if with respect to significant items in the report covered by the certificate any auditing procedures generally recognized as normal have been omitted, a specific designation of such procedures and of the reasons for their omission; (B) shall state whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances; and (C) shall state whether the audit made omitted any procedure deemed necessary by the accountant under the circumstances of the particular care.

(3) Nothing in this rule shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required by paragraph *(h)* of this rule.

(h) Accountant's Certificate—Opinions To Be Expressed. The accountant's certificate shall state clearly the opinion of the accountant with respect to the financial statement covered by the certificate and the accounting principles and practices reflected therein.

(i) Accountant's Certificate — Exceptions. Any matters to which the accountant takes exception shall be clearly identified; the exception thereto shall be specifically and clearly stated; and to the extent practicable, the effect of each such exception on the related item of the report shall be given.

Instructions to SEC Form X-17A-5, Report of Financial Condition of Member Broker or Dealer.

The following are the instructions which appeared on the Form prior to November 30, 1967. They are reprinted from Louis H. Rappaport, SEC Accounting Practice and

Procedure, pp. 4-37 and 4-38 (2nd Ed. 1966). The current instructions appear at App. 166 and 167.

The audit shall substantiate the stated assets and liabilities as of the date of the financial questionnaire and the scope and comprehensiveness thereof shall be such as would enable the independent public accountant to express an opinion as to the stated financial condition of the respondent as of that date.

The scope of the audit shall include at least the following:

1. Comparison of ledger accounts with the trial balances obtained from the general and private ledgers and proofs of the aggregates of subsidiary ledgers with their respective controlling accounts.
2. Physical examination and comparison with the books and records of all securities, currencies, tax stamps, warehouse receipts, and other such assets on hand, in vault, or in box, or otherwise in physical possession.
3. Verification of securities in transit or in transfer.
4. Balancing of positions in all securities and spot and future commodities as shown by the books and records.
5. Obtaining of written confirmations with respect to the following: . . .
   (a) bank balances; (In addition to the reconcilement and confirmation of bank balances as of the date of the audit, the independent public accountant shall, at a later date, after giving ample time for clearance of outstanding checks and transfers of funds, obtain from depositaries canceled checks and statements of the bank accounts as of such date, and reconcile the balances shown thereon with the bal-

ances shown by the books of the respondent.)
   (b) open contractual positions and deposits of funds with clearing corporations or associations;
   (c) money borrowed and detail of collateral;
   (d) accounts, commodities, securities, and commitments carried for the respondent by others;
   (e) details of:
      (i) securities borrowed
      (ii) securities loaned
      (iii) securities failed to deliver
      (iv) securities failed to receive
      (v) when issued contracts
      (vi) delayed delivery and other similar open contracts
      (vii) open commodity contracts with others;
   (f) customers', partners', officers', directors' and respondent's accounts; (Confirmation of these accounts may be in the form of a written acknowledgment of the accuracy of the statement of balances, security positions, and open contractual commitments, other than uncleared regular way purchases and sales, accompanying the first request for confirmation mailed by the independent public accountant.)
   (g) guarantees in cases where required to protect accounts guaranteed as of audit date;
   (h) all other accounts which in the opinion of the independent public accountant should be confirmed.
6. A written statement should be obtained from the proprietor, partner (if a partnership) or officer (if a corporation) as to the assets, liabil-

ities, and accountabilities, contingent or otherwise, not recorded on the books of the respondent.

7. The independent public accountant shall review the methods of internal accounting control of the respondent and its procedures for safeguarding securities. * * *

QUESTIONS PRESENTED

1. Where the auditor of a stockbroker fails to comply with audit requirements of SEC Rule 17a-5 and violates generally accepted auditing standards, is it liable under §10(b) and Rule 10b-5 to persons who suffer losses as a result of such failure and violation?

2. Where there is evidence from which the trier of fact might find recklessness or scienter (if such is required for auditor liability), may summary judgment be entered for the auditor?

3. May plaintiffs, on summary judgment, be held estopped to complain of a fraud and federal securities law violations where they were unaware of the fraud and the violations at the time of the events giving rise to the claim of estoppel? Where varying interpretations and inferences may be drawn from documents claimed to give rise to the estoppel, may the issue be determined on summary judgment?

4. Are plaintiffs' claims barred by the statute of limitations?

STATEMENT OF THE CASE

Plaintiffs were swindled in a total sum of $1,073,000. Presently, it appears that they are likely to recover about $200,000 in the First Securities equity receivership pro-

ceedings in the United States District Court for the Northern District of Illinois, Case No. 68 C 1053. Such recovery will reduce to about $873,000 their principal claims against Ernst & Ernst.

Plaintiffs charge Ernst & Ernst, the First Securities auditor, with four specific audit deficiencies in support of their cause of action. Petitioner's lengthy statement of the case (E.&E. Br. 16) touches only briefly on one, Nay's mail rule (E.&E. Br. 7 and 8). It fails to relate the three others. The acts of wrongdoing charged are:

1. *Ernst & Ernst's knowledge of the mail rule and failure to take corrective action.* As the Court of Appeals observed, 503 F.2d 1100, 1109 (Pet for Cert 13a), "Nay's 'mail rule' was an office rule which he imposed on all employees of First Securities whereby he directed that all mail addressed to him or to the company for his attention was to be opened by no one other than him and that when he was away from the office the mail was to be placed on his desk unopened regardless of the duration of his absence from the office."

Roy E. Campbell, cashier, assistant secretary, secretary, office manager, and a director of First Securities, in his affidavit in support of the Ernst & Ernst motion for summary judgment (App. 95), after relating the substance of the mail rule as above (App. 97-99) added that Nay, when out of town would request that "some or all of his unopened mail be forwarded to his residence for his review upon return to Chicago" (App. 99). He was "insistent that only he open his mail" (App. 99). On one occasion when securities which Campbell had been expecting from a customer were received in an envelope addressed to Nay's attention, Campbell, in violation of the rule, opened the envelope and recorded the receipt of securities. "Nay later

complained strongly to me of the violation of the office rule." (App. 99).

Ernst & Ernst auditors assigned to First Securities during the 1946 to 1967 period were questioned on deposition regarding their awareness of, and response to, the mail rule.

Jerry M. Hooker, assigned to the account from 1957 to 1967, testified that during his time it was the custom to conduct surprise audits (App. 235). During the first few days of the audit, Mr. Hooker and the other Ernst & Ernst auditors watched in the morning as the bundle of mail was untied and the mail opened in their presence. A letter addressed to Nay was not opened but was put aside for him (together with mail addressed to other individuals) (App. 239). The remaining mail was inspected for securities and checks. Mr. Hooker, on being asked when he first became aware of the mail rule, testified that he could not say when he became aware of "everything," but that his recollection of the mail procedure was as stated by Mr. Campbell in his affidavit (App. 95, at 97-99). At no time did Mr. Hooker raise any objection to the practice or ask to see the mail so set aside. He never asked Mr. Campbell what the rules regarding mail were at First Securities (App. 241-2). He simply learned about the mail rules "by observing it to a large extent" (App. 242). He never spoke to Nay himself with regard to the rules (App. 243) and he never asked any other person whether any special rules with regard to handling of mail had been made (App. 243).

Newell P. Crockett testified that during the period from 1952-1957 checking the mail for one or two days was a part of the audit (App. 327). "At the time when the auditors first looked at the mail the mail had been sorted and mail

addressed to First Securities Co. was supposed to be turned over to us unopened, but not a letter addressed to Nay or a salesman, nor was a letter addressed to First Securities, attention Mr. Leston B. Nay, turned over to the auditors." (App. 330). The mail addressed solely to First Securities was then opened and securities were listed. He did not recall whether it was the practice to read correspondence that might be included in the mail that the auditors did examine (App. 331-2). Consequently, if a customer wrote to complain that he had not received stock he had purchased some time ago, he would not read such a note (App. 332). Mr. Crockett, like Mr. Hooker, made no inquiries of anybody at First Securities regarding the procedures for handling the mail (App. 334). Mr. Crockett, when asked whether he was aware of the mail procedure set out in Mr. Campbell's affidavit, answered "I presume so." (App. 336). He was not aware that Mr. Nay had requested that no person other than himself open mail addressed to him personally or to his attention (App. 336), and he never inquired of Nay or Campbell or the mail clerks whether Nay had given any special rules regarding the handling of mail (App. 336).

Leroy E. Kist, who worked on the audit from 1946-1952, stated that he participated in a mail check (App. 307). He was not aware of the mail-handling practices described in the Campbell affidavit (App. 309-10) and did not know that Nay's mail was placed on his desk unopened (App. 310).

2. *Ernst & Ernst's awareness of other internal control deficiencies and failure to take action.* On February 6, 1948, Ernst & Ernst wrote to Nay (Hooker Ex. 1, App. 270) stating that it had reviewed the system of internal controls and found them "relatively limited" due to the size of the

organization. It recommended that "as many safeguards as may be considered practicable should be employed." (Ex. 1, App. 270). There followed three pages of suggestions including a recommendation that First Securities use prenumbered receipts for all securities received for the accounts of customers. This reform was "to give a considerable measure of assurance that all such securities are actually recorded in the long and short records as well as in the customers' accounts. We again suggest that you work out a system involving prenumbered security receipt and delivery forms so that this method of control can become an effective part of your accounting procedures." The use of such receipts was never instituted. Ernst & Ernst did not take an exception in its audit report and did not report the failure to adopt the recommendation to the Securities and Exchange Commission or other authorities (Kist Dep., App. 317)

Ernst & Ernst in a 1965 memo, under the heading "Evaluation of Accounting Procedures and Internal Controls," observed that due to the centralization of functions in the cashier "the overall system of internal control is weak" (App. 279). It again recommended use of prenumbered receipts (App. 278). Ernst & Ernst recommended also mailing monthly statements to customers, a practice followed only for customers who requested it (App. 277). The memo adds, "The client has objected on the grounds that it costs too much." (App. 277). First Securities did not adopt prenumbered receipts and refused to send monthly statements. Ernst & Ernst failed to take an exception in its audit report and failed to report the matter to the SEC (Hooker Dep., App. 245-6).

3. *Ernst & Ernst's failure to determine the collectibility of large sums due First Securities from Nay.* The bal-

ance sheets certified by Ernst & Ernst set out the amount due from "officers or employees." These sums were actually due from Nay (App. 266-7). The sums were relatively nominal until 1958, after which they mounted as follows:[1]

Hooker Exhibit No.	Balance Sheet for Year	Amount Due from Nay on Balance Sheet
17 (App. 282)	1958	$12,652
18 (App. 283)	1959	12,694
19 (App. 284)	1960	38,850
20 (App. 285)	1961	36,900
21 (App. 286)	1962	40,000
22 (App. 287)	1963	38,719
23 (App. 288)	1964	48,379
24 (App. 289)	1965	46,900
25 (App. 290)	1966	54,132
26 (App. 291)	1967	84,436

Mr. Hooker testified that he verified from Nay that he owed the money to First Securities (App. 267). Mr. Hooker, however, made no inquiry into the collectibility of this obligation. At no time did Ernst & Ernst set up a reserve for bad debts with respect to amounts due from Nay (Hooker Dep., App. 266-7).

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[1]Hooker Exhibits 17-26 are not printed in full in the appendix. These exhibits, and unless otherwise indicated, all other exhibits referred to for which no appendix reference is given, appear in an acco binder labeled "Plaintiffs' Exhibits in Opposition to Ernst & Ernst Motion for Summary Judgment." The exhibits in the acco binder, many of which appear in the appendix, are as follows: Exs. 1 to 29 to the deposition of Jerry M. Hooker, Exs. 1 to 4 to the deposition of Newell Crockett, Schueren Exs. I-78 and I-79, I-624, 3-69 to 3-75, Receiver's Exs. 13 and 14, Ernst & Ernst Ex. 1, Ex. 9 to the deposition of Carl E. Ogren, and affidavit of Willard J. Lassers, dated May 3, 1973. A table of exhibits appears in the front of the volume.

As of October 31, 1967, the date of the last audit of First Securities, the amount owed by Nay to the company was $84,436. At that time the net worth of the company as shown on the balance sheet was about $129,965.[1] The debt from Nay thus was about 65% of the net worth of the company.

4. *Ernst & Ernst's concealment of a "net capital violation as of October 31, 1967, its filing a false audit certificate, and its preparing a false Form X-17A-5 for the SEC.* Ernst & Ernst made its last audit of First Securities as of October 31, 1967. During the audit Mr. Hooker determined that the "aggregate indebtedness" of First Securities was more than twenty times its "net capital." Such condition was a violation of §8(b) of the 1934 Act, 15 U.S.C. §78h (b), and also of the rules of the Midwest Stock Exchange ("Midwest") (see pp. 32-3 below). The "net capital deficiency," that is, the amount of additonal capital required to bring the ratio down to 20, was $9,339.66 (Hooker Ex. 27, App. 292-4).

Mr. Hooker discussed the deficiency with an official of Midwest. His memorandum of the conversation, dated December 6, 1967, states (App. 410):

> "First Securities Co. of Chicago 10-31-67 comments—re significant matters.
>
> "As of October 31, 1967 the Company did not meet the minimum capital requirements of the Midwest Stock Exchange by approximately $9,000. The Company was aware of this deficiency and corrected it in November, 1967. On December 6, 1967, I called Mr. Frank Rothing, Vice President and Treasurer of the Midwest Stock Exchange (who was aware of the deficiency and that it had been corrected). Mr. Rothing said that the Exchange did not believe that the disclosure of the deficiency in the questionnaire was appropriate since it had been corrected. We agreed. Mr. Rothing said that if a company had a deficiency which was not corrected within a reasonable time, the Exchange would suspend the company from trading."

[1] Consisting of capital stock, $30,000; "other capital," $16,974 and retained earnings, $137,922; less treasury stock, $54,931. (Hooker Ex. 26, App. 291).

Mr. Hooker did not take an exception on the certificate certifying as to the condition of First Securities as of October 31, 1967, and did not mention the deficiency in the SEC Form X-17A-5 (App. 63).

The four acts of wrongdoing were first spelled out for Ernst & Ernst in the answers of the plaintiffs to Ernst & Ernst interrogatory 73 (App. 79-81). Their answer to interrogatory 74 accused Ernst & Ernst of "inexcusable negligence" in taking money "for certifying a condition contrary to the facts and failing to report irregularities, known to it, or which should have been discovered by it, its report of which would have led to the discovery of Nay's fraud." (App. 81).

The four charges were argued in the plaintiffs' brief in opposition to the Ernst & Ernst motion for summary judgment, and in their brief in the Seventh Circuit.

SUMMARY OF ARGUMENT

Under Rule 56(c), F.R.C.P., summary judgment may be entered against a party only if there is no genuine issue as to any material fact. In Point I, pp. 19-34, plaintiffs contend that the Seventh Circuit properly reversed an order granting summary judgment in favor of Ernst & Ernst, in light of the fact that there are such genuine issues. Plaintiffs charge, pp. 25-33, that in four respects Ernst &

Ernst violated generally accepted auditing standards and acted negligently or recklessly: it had actual knowledge of Nay's mail rule, a key to the fraud, but failed to report the facts to the authorities or take an exception on its audit certificate; Ernst & Ernst itself made recommendations to tighten internal controls which it declared "relatively limited." The recommendations were never adopted, yet Ernst & Ernst failed to report the matter or take an audit exception; it knew that Nay had borrowed heavily from First Securities and that his debt constituted 65% of the net worth of the firm, yet it did nothing to ascertain the collectibility of the indebtedness; it knew that as of the date of the last audit First Securities was in violation of the "net capital" ratio rules yet it deliberately omitted this violation from its audit report and report to the SEC.

Point II, pp. 34-60, contends that the Court below correctly held that where an auditor voluntarily undertakes to make an SEC audit, it is liable in damages for violation of SEC audit regulations and for its failure properly to conduct the audit. Plaintiffs, pointing out the Congressional purpose in protecting investors, pp. 35-37, stress the special financial and other hazards facing the brokerage customer, pp. 37-43, citing as to the details the SEC's 1963 Special Study. SEC Rule 17a-5, discussed at pp. 43-50, issued pursuant to §17(a) of the 1934 Act requiring brokers to maintain specified books and records, requiring that such records be subject to periodic audit, and requiring the filing of a periodic report with the SEC is of special importance in the field of securities regulation because it provides the base upon which to determine broker solvency and also compliance with other regulations, pp. 44-48. Thus, for example, the SEC's investigatory

powers under §21(a) of the 1934 Act depend for their full effectiveness on complete and accurate records. Similarly, private actions against brokers, an important part of securities enforcement, depends on such records. Following the 1969-70 broker collapse, Congress imposed additional requirements on the industry. Compliance with these new requirements, too, is capable of verification by audit and indicates that SEC audit regulations have an even greater importance.

Next plaintiffs demonstrate, pp. 50-52, that each of the four violations charged to Ernst & Ernst are in fact violations of the SEC audit regulations and the official Instructions to the SEC audit form.

The SEC concurs with plaintiffs that negligence is an adequate basis for auditor liability under §10(b). But, the SEC adds, absent recklessness, an auditor's liability for failure to observe generally accepted auditing standards should be limited. As the SEC recognizes, questions of damages have not heretofore been considered by the parties or the courts below and appear not to be before this Court. In any event, plaintiffs argue, pp. 52-60, the SEC limitations find no support in the statutes, the case law, or in policy. If, however, this Court concludes that plaintiffs must prove recklessness to avoid damage limitations or must, as Ernst & Ernst contends, prove recklessness or scienter, then, on this record this brief contends in Point III, pp. 60-66, this Court should remand the case for trial on such issues.

Point IV argues, pp. 66-77, that Seventh Circuit held correctly that on summary judgment plaintiffs could not be held estopped from asserting their claims against Ernst & Ernst. At the time of the events giving rise to the estoppel, plaintiffs were unaware of the frauds committed

on them and of their claims against Ernst & Ernst. The documents relied on for the estoppel as noted at pp. 69-73 are capable of varying interpretations rendering summary judgment inappropriate.

In Part V plaintiffs contend that the Seventh Circuit correctly held that plaintiffs' claims were not barred by any limitation period. In actions under §10(b) and Rule 10b-5 the right was created by Congress but both the remedy and the time limitation on suit are creatures of the federal courts. In these cases the rule invariably is stated to be that the limitation period does not begin to run against plaintiffs until plaintiffs discover, or by the use of reasonable diligence should have discovered, the existence of the facts giving rise to their cause of action. This rule applies to all defendants in actions under §10(b) and Rule 10b-5, including those who, though themselves innocent of fraud, contributed by wrongful conduct to the success of a fraud perpetrated by others. Even if the limitation period commenced prior to the plaintiffs' knowledge of the fraud, summary judgment should not have been entered indiscriminately against the plaintiffs. Some of the plaintiffs made escrow investments less than three years prior to the filing of this suit.

ARGUMENT

I.

THE SEVENTH CIRCUIT CORRECTLY HELD THAT GENUINE ISSUES OF MATERIAL FACT PRECLUDE SUMMARY JUDGMENT FOR ERNST & ERNST.

A. The Contentions of the Parties, the SEC and the AICPA.

The Ernst & Ernst brief (29-59) views the case, inexplicably, as if nearly the sole charge against it was one of negligence for its failures in connection with the mail rule. Negligence, it contends, is an insufficient basis for liability under §10(b), 15 U.S.C. §78j(b), and Rule 10b-5, 17 C.F.R. §240.10b-5 (E.&E. Br. 29-59). In any event, it adds, it conducted its audits in accordance with generally accepted auditing standards (E.&E. Br. 60-77), reaching this conclusion by preferring the affidavits it filed in support of its motion for summary judgment to those filed by the plaintiffs in opposition.

The AICPA specifically disclaims a view as to whether Ernst & Ernst adhered to generally accepted auditing standards (AICPA Br. 9, n.3). It, too, assumes that the sole question is whether §10(b) and Rule 10b-5 liability may be founded on negligence.

The SEC takes the view that an action will lie against an auditor for negligence in the performance of its work (Pt. I, 10-22). The SEC, however, in its Point II, pp. 23-32, urges this Court to limit the liability of auditors for negligent §10(b) violations. Full recovery, unimpeded by the proposed negligence limitations would be allowed for reckless violations (SEC Br. 32). The restrictions

on damages for negligence urged by the SEC were not, as it recognizes, presented in the lower courts. Had they been, "respondents might have presented their case on a different basis. Moreover, respondents' answers to interrogatories suggest that respondents may contend that in auditing First Securities, Ernst & Ernst was more cupable than merely performing its work negligently, *i.e.*, the alleged deficiencies in the audit may have resulted from intentional or reckless conduct (App. 81; see also, brief of respondents Olga Hochfelder, *et al.*, at 12-14)."

The SEC concludes by stating, "If that is respondents' contention [and indeed it is], the district court might permit them to amend their complaint to reflect that theory. In the circumstances, it would be appropriate to modify the court of appeals' judgment to require that the further proceedings on remand be in accordance with the principles set forth in this brief." (SEC Br. 36).[1]

The plaintiffs adopt the view of the SEC in its Pt. I (SEC Br. 10-22) that negligence is a sufficient basis for §10(b) and Rule 10b-5 liability. In addition to the arguments advanced by the SEC, the plaintiffs contend that Ernst & Ernst voluntarily undertook audits of First Securities required of it by SEC Rule 17a-5, 17 C.F.R. §240.17a-5, issued pursuant to §17(a) of the 1934 Act, 15 U.S.C. §78q(a). These audits, for the reasons set out in Point II, Parts B-E below (pp. 37-60), are critical significance to the public and known to be such by Ernst & Ernst. Proof that Ernst & Ernst violated generally accepted auditing principles should be, plaintiffs claim, sufficient to establish liability.

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[1] If the SEC caption to its Point III (SEC Br. 33) indicates a contrary disposition, its textual discussion (SEC Br. 36) should control.

The plaintiffs ask the Court to reject the limitations on negligence liability suggested by the SEC, urging in this connection that the precise nature of the acts of wrongdoing charged to Ernst & Ernst make them irrelevant in the case at bar. In any event, the plaintiffs contend (Pt. III, pp. 60-66 below) there is enough in the present record from which the trier of fact might conclude that the behavior of Ernst & Ernst was reckless. Such finding would be an adequate basis for imposition of liability without the special limitations the SEC would apply to negligence liability (SEC Br. 32).

The plaintiffs dispose of the Ernst & Ernst estoppel defense in Pt. IV, pp. 66-77, and its statute of limitations defense in Pt. V, pp. 77-93.

B. Standards Relating to Summary Judgment.

From the foregoing analysis, it is apparent that if this Court adopts the view of the SEC and the plaintiffs as to the scope of §10(b) and Rule 10b-5, the trier of fact should be allowed to decide the question whether Ernst & Ernst violated generally accepted auditing standards in connection with its First Securities audits. The SEC speaks of "negligence." The separate phrasings of the issue are in fact equivalent since the test of whether an auditor is negligent in connection with the auditing function is determined by asking whether he violated generally accepted auditing standards.

If the Court should conclude that more than negligence is a prerequisite to liability, then the trier of fact should be allowed to determine whether Ernst & Ernst acted recklessly. In either event, affirmance of the judgment below and remand for further proceedings is appropriate.

The ultimate issue in this case is whether the District Court erred in granting summary judgment to defendants.

As the District Court granted summary judgment, the record consists solely of the affidavits, interrogatories and depositions filed in the District Court. The trier of fact has not observed witnesses and has not had the opportunity to determine the weight and credibility of their testimony. In holding that material issues of fact exist to preclude summary judgment, the Court of Appeals did not hold that Ernst & Ernst is liable to plaintiffs, but only that plaintiffs are entitled to present their case to the trier of fact.

Rule 56(c) F.R.C.P. establishes the basic criteria for summary judgment:

> "The judgment sought shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law. . ."

The device of summary judgment is not a substitute for a trial of a case on its merits. Rather,

> "Rule 56 authorizes summary judgment only where the moving party is entitled to judgment as a matter of law, where it is quite clear what the truth is, [and] that no genuine issue remains for trial. . ."

Sartor v. *Arkansas Natural Gas Corp.*, 321 U.S. 620, 627, 88 L.ed 967 (1944); *Poller* v. *Columbia Broadcasting System*, 368 U.S. 464, 468, 7 L.ed 2d 458 (1962); *Associated Press* v. *United States*, 326 U.S. 1, 89 L.ed 2013 (1945). Rule 56 should be "cautiously invoked to the end that parties may always be afforded a trial where there is a bona fide dispute of facts between them," *Associated Press* v. *United States, supra,* and when the rule is invoked, the Court may not resolve factual disputes or

make determinations of the weight or credibility of the evidence before the Court. *United States* v. *Diebold,* 369 U.S. 654, 655, 8 L.ed 2d 176 (1962); *SEC* v. *Spectrum, Ltd.,* 489 F.2d 535 (2d Cir. 1973).

In making its determination as to whether there are genuine issues of material fact, the "inferences to be drawn from the underlying facts contained in [the affidavits, exhibits and depositions] must be viewed in the light most favorable to the party opposing the motion," *United States* v. *Diebold, supra,* at 655; *Adickes* v. *S. H. Kress & Co.,* 398 U.S. 144, 158-9, 26 L.ed 2d 142 (1970); *Poller* v. *Columbia Broadcasting System, supra,* at 473. If the underlying facts and the inferences which may reasonably be drawn from them will support a verdict for the party opposing summary judgment, summary judgment must be denied, and this is true, whether or not the party opposing summary judgment presents any evidence in opposition to summary judgment. *Adickes* v. *S. H. Kress & Co., supra,* at 159-60. Finally, where the movant relies upon the affidavits or testimony of experts, as does Ernst & Ernst in the present case, that testimony has weight only "as expressions" of opinion . . .

> "plainly opinions thus offered, even if entitled to some weight, have no such conclusive force that there is error of law in refusing to follow them. This is true of opinion evidence generally, whether addressed to a jury or to a judge. . . The rule has been stated 'that if the court admits the testimony, then it is for the jury to decide whether any, and if any what weight is to be given to the testimony. . .' The jury, even if such testimony be uncontradicted, may exercise their independent judgment."

Sartor v. *Arkansas Natural Gas Corp., supra,* at 627-8. Where the expert has an interest in the outcome of the

proceedings, as it is the case with Ernst & Ernst's partner, Jerry Hooker, "the mere fact that the witness is interested in the result of the suit is deemed sufficient to require the credibility of his testimony to be submitted to the jury as a question of fact." *Id.* The affidavit of John Walsh (App. 197), a partner of a large auditing firm, seems to be subject to the same infirmity. Plaintiffs submit that an application of these principles to the evidence in the record precludes summary judgment for Ernst & Ernst, regardless of the standard of liability which this Court determines to be applicable.

C. The Genuine Issues of Material Fact.

We have observed above, that regardless of the standards of liability adopted by this Court, factual questions remain for resolution. At trial, the plaintiffs hope to establish four negligent or reckless violations of generally accepted auditing standards by Ernst & Ernst. Indeed, as to a fourth violation, the evidence is clear that it was committed not negligently or recklessly, but knowingly and wilfully. Proof of any one of the four charges is adequate to sustain a judgment as to liability.

Despite the fact that all four violations were spelled out for Ernst & Ernst long before it filed its motion for summary judgment (see above, p. 15), in its motion it chose to respond only to the violation respecting the mail rule. It did so by submitting the affidavits of Hooker (App. 102) and of John F. Walsh, a partner of Haskins & Sells (App. 148). Thus Ernst & Ernst made no attempt to counter the three other violations asserted.

The genuine issues as to material facts, resolution of any of which in favor of the plaintiffs will sustain a judgment of liability, are as follows:

1. *Was Ernst & Ernst negligent or reckless with respect to the mail rule?* The affidavit of Hooker (App. 102) submitted by Ernst & Ernst, avers that "in no circumstances will the existence of a procedure with respect to mail, as described by Mr. Campbell, be relevant to or determinative of the existence or lack of internal accounting controls for any purposes. . ." (App. 105). The affidavit of Walsh (App. 148) is similar.

To counter the affidavits of Hooker and Walsh, the plaintiffs submitted affidavits by certified public accountants Gerhard Mayer (App. 172) and Fred J. Duncombe (App. 174) and of National Bank Examiner Michael K. Garst (App. 168).

Particularly relevant is the affidavit of Mr. Mayer. After stating his qualifications (App. 172), Mr. Mayer declares that "standard practice" requires inquiry into "internal controls" (a term he defines). Any significant failure to yield "an affirmative, independently verified answer would militate against issuing an accountant's report stating that the financial statements fairly present the financial condition of the organization being audited." Further, "Failure to periodically make such investigation and evaluation would seem to constitute a significant departure from usual auditing standards" (App. 172-3).

There follows this key paragraph:

> 4. If I had discovered in making an audit of a security brokerage business that its president had established an office rule that mail addressed to him at the business address, or to the company for his attention should not be opened by anyone but him, even in his absence; and that whenever he was away from the office such mail would remain unopened

> and pile up on his desk I would have to raise the question whether such rule or practice could possibly have been instituted for the purpose of preventing discovery of irregularities of whatever nature; would, as a minimum, have to undertake additional audit procedures to independently establish a negative answer to the latter question; also, failing such an answer ether withdraw from the engagement or decline to express an opinion on the financial statements of the enterprise. I would do so for the reasons that (i) such a rule or practice is unusual and strange; and (ii) in a securities brokerage business the risk to the investing public from any irregularity is particularly severe in view of the fact that its capital usually is much smaller in relation to its liabilities than in most other lines of business. (App. 173-4).

The affidavit of Mr. Duncombe concurs with the Mayer affidavit (App. 174-6).

Despite the Mayer and Duncombe affidavits, Ernst & Ernst argues in this Court in its Point II (E. & E. Br. 60-78, and particularly 67-78) that this Court can conclude that it did not violate generally accepted auditing standards. In this respect it repeats the error of the District Court (Pet. for Cert. 35a at 38a) which similarly decided a factual issue on the basis of affidavits.

Ernst & Ernst urges such action in face of the fact that the hypothetical situation posed in Mayer's affidavit expresses precisely the facts at bar. On the basis of those facts, Mayor states that he would have suspected additional irregularities and, in the exercise of the due care required of auditors, he would have investigated to determine if such irregularities existed. Ernst & Ernst does not contend that the hypothetical misstates any of the facts in this case or dispute Mayer's assertion that he would "as a minimum" have been required to "under-

take additional audit procedures to independently establish" that the mail rule had not been instituted to cover other, more serious irregularities. Rather, Ernst & Ernst, who concededly undertook no further investigation, relies upon its assertion that the mail rule, through which Nay succeeded in defrauding plaintiffs of more than $1,000,000, was not a material inadequacy in the internal controls of First Securities. Thus, the affidavit of Mr. Mayer alone establishes that there is a genuine issue of material fact in this case not only as to whether Ernst & Ernst's failure to investigate was a violation of generally accepted auditing principles, but also as to whether Ernst & Ernst's knowledge of the mail rule was sufficient to put it on notice that other irregularities existed.[1]

When the Mayer affidavit is read in conjunction with the Hooker, Crockett and Kist depositions, it becomes clear that there is a genuine issue of fact as to whether Ernst & Ernst acted negligently or recklessly in permitting the mail rule to go uninvestigated. The depositions reveal that the mail rule was not simply a rule that Ernst & Ernst failed to discover because of their failure to comply with generally accepted auditing principles. Rather, the depositions demonstrate that Ernst & Ernst had *actual knowledge* of the existence and operation of the mail rule for 15 years and yet failed to take action. Hooker and Crockett observed the practice and, when sent specifically to check mail transactions, actually permitted letters addressed to Nay and to First Securities to Nay's

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[1] See, e.g., *Blakely* v. *Lisac*, 357 F.Supp., 255, 266 (D. Ore. 1972):

> "Even when performing an unaudited write-up, an accountant is under a duty to undertake at least a minimal investigation into the figures supplied to him. He is not free to disregard suspicious circumstances."

attention to be set aside for him without their inspection. It is difficult to comprehend how an auditor specifically assigned the task of determining whether mail was being properly handled would permit or tolerate a practice which permitted Nay to create a private channel within the organization through which correspondence could bypass all persons in the firm but him.

The mail rule was the key not only to frauds on the plaintiffs but also to frauds on other customers of First Securities in their direct dealings with the firm. These were dealings, of course, that should have been, but were not, recorded on the books and records audited by Ernst & Ernst, and as to the reliability of which Ernst & Ernst had expressed an opinion. The defrauded parties have established their claims through litigation and hence there can be no question as to the facts.[2]

Arnold Schueren and his wife, Mrs. Eleanor Schueren, in the 1930s deposited securities for safekeeping at First Securities. Nay embezzled $394.000 in securities from Mr. Schueren and $17,000 from Mrs. Schueren. (See *SEC* v. *First Securities Co. of Chicago,* 466 F.2d 1035 (7th Cir. 1972), *cert. denied,* 409 U.S. 1041 (1972). Nay's suicide note, dated May 31, 1968 (App. 395) states "Defalcation of Schueren's securities started in 1938, I think, whenever his first Power of Attorney to me is dated (see one of the files in bottom drawer of safe—also see "Receipt" I issued for his securities in "safekeeping" received by

[2] As Ernst & Ernst states (E. & E. Br. 4) on a motion for summary judgment a court may take judicial notice of facts established in prior proceedings. See, e.g., *U.S.* v. *Webber,* 396 F.2d 381, 386 (3rd Cir. 1968); *Soley* v. *The Star & Herald Co.,* 390 F.2d 364, 367 (5th Cir. 1968); *Chandler* v. *O'Bryan,* 311 Supp. 1121, 1122-23 (W.D. Okla. 1969).

Ryan Nichols & Co. from Webber Darch & Co. in June of 1942. . ." (App. 398).

The power of attorney, referred to by Nay, actually was dated July 7, 1937. Thus, the Schueren frauds had been under way for nine years when Ernst & Ernst began to audit the First Securities books in 1946. The ledger sheets of Arnold Schueren, marked Receiver's Ex. 13, appear at App.402-05. The ledger sheets show that Arnold Schueren had a zero balance on the books of the company after 1963 and hardly any transactions after 1958. Mrs. Schueren's ledger sheet, Receiver's Ex. 14, appears at App.405 and App.409. Mrs. Schueren's account shows a zero balance after 1962, with few transactions after 1957.

Schueren died early in 1967. His will named the Union Bank of Helena, Montana, as his executor. In 1957, Schueren informed the Union Bank that his securities were being held in safekeeping at First Securities (Schueren Ex. I-624) and that Leston B. Nay was president of the company. After Schueren's death, the Union Bank addressed a letter dated March 3, 1967 to "Leston B. Nay, President, First Securities Co. of Chicago" (Schueren Ex. I-78, App.393), requesting First Securities to forward to it all securities and cash it was holding for Schueren. Under the mail rule this letter would have been delivered unopened to Nay. But for this fact, others in the company would have been aware immediately that the Union Bank was making claims for amounts being held in the account of Mr. Schueren and that his account had shown a zero balance since 1963. Nay stalled the bank for over a year until June, 1968, at which time he committed suicide and the facts came to light. See the suicide note and covering letter at App.395, et seq.

In addition to the Schueren trusts, Nay embezzled $175,000 in securities from Mrs. Nora Moyer. See the suicide note, App.396, et seq.[1] The Schueren and Moyer embezzlements add more than $600,000 to Nay's thefts.

On the facts, the plaintiffs submit there is a genuine question of material fact whether Ernst & Ernst acted negligently or recklessly with respect to the mail rule.

2. *Was Ernst & Ernst negligent or reckless in failing to act upon other internal control weaknesses of which it was aware?* The record establishes that as early as 1948 (App.270), Ernst & Ernst urged that First Securities adopt pre-numbered receipts for cash and securities received from customers. It renewed the suggestion in 1965 (App.278). The recommendation was never adopted, yet Ernst & Ernst took no exception in its auditor's certificate to this fact (see above, pp. 11-12). The recommendation was not unimportant: Where unnumbered receipts are used, it is impossible to determine whether receipts have been issued but the transaction not recorded in the books and records of the Company. Numbered receipts, on the other hand, allow the auditor to insist upon an accounting for every receipt and to raise questions where receipts or book entries appear out of sequence.

Another major deficiency in First Securities' system of internal controls which Ernst & Ernst noted but did nothing to correct or report was First Securities' refusal to use monthly statements to customers. Like the use of prenumbered receipts, the use of monthly statements serves an important function in the detection or even

[1] As to the Moyer claim, see Master's Report of August 4, 1969 in the District Court proceedings in *SEC* v. *First Securities Co. of Chicago*, U.S.D.C., N.D. of Illinois, Eastern Division, Case No. 68 C 1053. The report was confirmed by the District Court on August 19, 1969.

prevention of defalcations. An embezzler must not only juggle the company books but must also juggle the monthly statement to prevent exposure.

Both the failure to use prenumbered receipts, and the failure to send out monthly statements may have facilitated the Schueren frauds. The plaintiffs should have an opportunity to so establish at trial. An examination of the ledger account of Arnold Schueren reveals numerous transactions over the years between 1946 and 1963. Had monthly statements been sent out showing the customer's security position at the end of the month, Arnold Schueren would have been put on notice immediately of the vast discrepancy between the securities supposedly held for him, as represented to him by Nay, and the securities held for him as reflected on his ledger account at First Securities. Once again Ernst & Ernst made a recommendation to First Securities regarding a sound practice. The recommendation was not accepted. Ernst & Ernst failed to take an exception in its financial statements and failed to report the matter to the SEC or any other regulatory authority. Its failure to do so may be deemed by the trier of fact to be negligent or reckless.

3. *Whether Ernst & Ernst was negligent or reckless in failing to ascertain the collectibility of Nay's debt to First Securities, or to set up a bad debt reserve therefor.* Between 1958 and 1967, Ernst & Ernst became aware that Nay was borrowing heavily from First Securities. By 1967, Nay's debt to the company equalled 65% of the total net worth of the company (see above, pp. 12-14). Ernst & Ernst verified with Nay the amounts of these unsecured debts but did no more. It never sought confirmation that the debts were collectible and never sought to have First Securities establish a reserve for bad

debts. Its failure to do so may be judged negligent or reckless.

4. *Whether Ernst & Ernst was negligent or reckless in its concealment of the "net capital" violation.* The record establishes that in December 1967, during the course of the First Securities audit as of October 31, 1967, Ernst & Ernst uncovered the First Securities violation of the net capital rule, yet deliberately failed to note it in its audit and on SEC Form X-17A-5 which it prepared (see above, pp. 14-15).

The consequences of the failure of Ernst & Ernst to report the net capital deficiency were serious. Under the rules of Midwest then in force, a firm whose net capital was less than $5,000 over the minimum [clearly the case with First Securities], had to file monthly reports with Midwest (Midwest Stock Exchange Rules, Article XX, Rule 3, CCH Midwest Stock Exchange Guide, p. 2403, 1967). Since the violation was not formally called to the attention of Midwest, it did not invoke this monitoring regulation.

Had the monitoring regulation been invoked, the fact finder may conclude that Nay might not have been able to steal another $30,000. The facts are as follows: Hooker apparently did not verify for himself whether the violation had been corrected as claimed. Nay, however, reported to Midwest that on November 13, 1967 he had repaid $10,000 to First Securities, bringing him into technical compliance with the net capital rule (Ogren Group Ex. 7). On December 8, two days after Hooker's call to Midwest on December 6, Nay withdrew the $10,000 from First Securities (Nay's letter of December 8, 1967, Ogren Ex. 7). Midwest, not officially alerted to the net capital violation, and not having invoked Article XX, did

nothing. The stage was set for the last theft: On April 18, 1968 Nay withdrew $30,000 from First Securities (Nay's letter of April 18, 1968 to Midwest, Ogren Group Ex. 7).

Since First Securities is clearly insolvent, this final withdrawal unquestionably prejudiced the plaintiffs because it reduced by that sum amounts available for creditors. As to the insolvency, see *SEC* v. *First Securities Co. of Chicago,* 507 F.2d at 420, n.3. Allowed claims against First Securities are about $2,280,772. Assets as of September 15, 1973 were about $1,050,000.

To this point, we have viewed the four asserted violations of generally accepted auditing standards in isolation, as though each could be, or should be, regarded separately from the other. This is of course not the case. The fact finder will have before him not four isolated sets of facts but a comprehensive picture. Thus the mail rule may take on a new significance for him when viewed in the light of the refusal to use prenumbered receipts, the refusal to send out monthly statements, Nay's evident incessant money needs, and the borderline condition of the firm in 1967. The "material facts" at issue here are essentially judgmental in character—whether a professional adhered to the standards of his profession. Necessarily their determination requires expert testimony. In any case, this Court customarily is slow to award summary judgment where there may be a factual dispute. Unusual caution is desirable where the "facts" essentially represent a judgmental decision.

II.

THE COURT OF APPEALS CORRECTLY HELD THAT WHERE AN AUDITOR VOLUNTARILY ACCEPTS A FEDERAL STATUTORY DUTY TO PERFORM AN AUDIT IN ACCORDANCE WITH GENERALLY ACCEPTED AUDITING STANDARDS, IT IS LIABLE IN DAMAGES FOR ITS NEGLIGENT CONDUCT OF THE AUDIT.

Neither Ernst & Ernst nor the AICPA dispute that under §10(b) and Rule 10b-5 an implied private right of action will lie against an aider or abettor of a securities fraud. This proposition is well founded in the decisions of this Court and on Congressional intent in enacting the securities acts. Noting that Congress, in enacting the securities acts, intended to establish a broad remedial statute which was designed for the protection of investors in modern securities transactions, *SEC* v. *Capital Gains Research Bureau*, 375 U.S. 180, 11 L.ed. 2d 237 (1963), this Court has consistently held that the acts must be construed broadly to effect the legislative purpose. *J. I. Case Co.* v. *Borak*, 377 U.S. 426, 12 L.ed. 2d 423 (1964); *Tcherepnin* v. *Knight*, 389 U.S. 332, 19 L.ed. 2d 564 (1967); *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 31 L.ed. 2d 741 (1972). Moreover, the courts must "be alert to provide such remedies as are necessary to make effective the congressional purpose," of protecting investors from being victimized by acts, practices or courses of business which "operate as a fraud or deceit upon" such investors. Rule 10b-5; *Mills* v. *Electric Autolite Co.*, 396 U.S. 375, 24 L.ed 2d 593 (1970). Liability for aiding and abetting a securities fraud is a necessary element in providing such protection.

A. The Congressional Purpose of Protecting Investors.

It is evident from the briefs submitted by Ernst & Ernst, the AICPA and the SEC, that the legislative history of the Securities Exchange Act provides no clear answer as to whether Congress intended to prohibit negligent as well as willful violations of the act. See, Jacabs, The Impact of Rule 10b-5 (1974). §§5.01 and 5.02. What is clear, however, is that Congress, working in light of the 1929 stock market disaster, intended to protect investors and, consequently, empowered the SEC to make such rules and regulations as it determined "necessary or appropriate in the public interest or for the protection of investors." §10(b), 15 U.S.C. §78j(b).

Shortly after enactment of the securities acts in 1933 and 1934, the securities world was rocked by the revelation that Richard Whitney, formerly a president of the New York Stock Exchange, had engaged in numerous frauds and embezzlements, as a result of which he was sentenced to prison for grand larceny.[1]

The dangers of fraud were again made evident in 1960 with the bankruptcy of Ira Haupt & Co. In that case, Haupt advanced money to Allied Crude Vegetable Oil Refining Company on the basis of fraudulent warehouse receipts. When Allied failed to meet Haupt's margin calls, Haupt was forced to declare that it could no longer meet the New York Stock Exchange's net capital rules and was subsequently adjudicated bankrupt. See, *Wineberger* v. *New York Stock Exchange*, 335 F.Supp. 139 (S.D.N.Y. 1971). As a result, the New York Stock

[1] The SEC published a three-volume report on this case in 1938. See, SEC, In the Matter of Richard Whitney (1938). For further details, see *Baird* v. *Franklin*, 141 F.2d 238 (2d Cir. 1944).

Exchange voluntarily donated $700,000 to the receiver of Haupt to protect Haupt's creditors from loss. It and other exchanges subsequently established special trust funds to pay benefits to customers of bankrupt brokers. Within a few years, it was apparent that such action was inadequate for customer protection.

This Court has repeatedly recognized that the Securities Act and the Securities Exchange Act "clearly falls into the category of remedial legislation," *Tcherepnin* v. *Knight*, 389 U.S. 332, 336, 19 L.ed 2d 564 (1967) whose interpretation "embodies a flexible rather than static principle," capable of "adaptation" to meet the varied factual situations in which the Congressional purpose is called into play. Id. at 338. Consequently, the Act must be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes." *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 151, 31 L.ed. 2d 741 (1972); *Superintendent of Insurance* v. *Bankers Life and Cas. Co.*, 404 U.S. 6, 12, 30 L.ed 2d 128 (1971). In so doing, the courts must be cognizant of Congress' intention to "impose a high standard of 'trusteeship'" upon those involved in the securities industry, *Globus* v. *Law Research Service*, 418 F.2d 1276 (2d Cir. 1969), and of the fact that "the doctrines of fraud and deceit which developed around transactions involving land and other tangible items . . . are ill-suited to the sale of such intangibles as . . . securities, and that, accordingly, the doctrines must be adapted to the merchandise in issue." *SEC* v. *Capital Gains Research Bureau*, 375 U.S. 180, 194, 11 L.ed 2d 237 (1963).

Plaintiffs submit that these considerations, when coupled with the fact that "in our complex society the accountant's certificate . . . can be [the instrument] for inflicting pecuniary loss more potent than the chisel or the crowbar," *United States* v. *Benjamin*, 328 F.2d 854, 863 (2d Cir. 1964), require this Court to impose a high standard of conduct upon auditors of securities brokers and to hold that an auditor is liable in damages to customers of a broker whose fraud is facilitated by a negligent audit.

Plaintiffs fully subscribe to the position taken by the SEC that §10(b) and Rule 10b-5 proscribe negligent, as well as willful or reckless conduct. The reasons for this proposition are set forth at length in the brief *amicus* of the SEC (SEC Br. 10 et seq.) and need not be restated here. Plaintiffs submit further that there are additional sound reasons of law and policy for imposing liability for the negligent conduct of the audit of a securities broker.

B. The Brokerage Customer's Special Perils.

In this Part B and Part C, pp. 43-50, plaintiffs show that the public is subject to extraordinary hidden perils in its dealing with brokers, arising from the nature of the business and the terms on which it is customarily conducted. The maintenance of complete, accurate, detailed and reliable brokerage records is accordingly an essential for public protection. Section 17(a) of the 1934 Act, and SEC Rule 17a-5, 17 C.F.R. §240.17a-5, mandate such records. The records, moreover, under Rule 17a-5, must be audited periodically and a certified report thereon filed with the SEC. This regulation is designed to provide the auditor with a firm record base on which to work in determining broker solvency and checking compliance with SEC regulations as required by SEC audit regulations. The record keeping, reporting, and auditing regulations serve further as the base upon which other regulatory and enforcement provisions necessarily rely for their effectiveness. Following the 1969-70

broker debacle, Congress recognized the need for additional record keeping and other regulations. The importance of the audit function is thus enhanced. This Court should be slow to adopt a rule that will weaken full, careful and complete compliance with SEC audit regulations.

Part D, pp. 50-52, shows that at trial, the fact finder may determine that each of the four audit violations charged to Ernst & Ernst was a violation of the Instructions to the SEC audit form. Part E, pp. 52-60, urges this Court on the facts at bar not to adopt the limitations on auditor's liability suggested by the SEC.

In its monumental "Special Study" of the securities industry concluded in 1963 (Report of Special Study of Securities Markets, H. Doc. 95, 88th Cong., 1st Sess. 1963), the SEC concluded that

> ". . . brokers, dealers, investment advisors, and their employees have special obligations to deal fairly with the members of the public, whether they be called customers or clients, and that these obligations are above and beyond the ordinary obligations imposed on sellers of other types of merchandise." (Pt. 1, p. 237).

The Special Study, in light of such fiduciary responsibility, analyzed not only brokers' selling and investment advice practices (Special Study, 242 et seq. and 330 et seq.) but also the financial arrangements between the broker and his customers. These arrangements are of particular concern in the present case because they point up many dangers to the public known to exist during the period Ernst & Ernst was auditing First Securities.

The Special Study spelled out the unusual hazards facing the general public in connection with broker-customer financial arrangements: The SEC analysis made

clear that while the broker might be a fiduciary or quasi-fiduciary, in general it was not required to segregate the customers' funds and securities from its own. The public therefore has an extraordinary need for protection because in the event of broker insolvency, he was, except to a limited extent (see *SEC* v. *First Securities Co. of Chicago*, 507 F.2d 417 (7th Cir. 1974)), a general creditor of the broker. The public, moreover, in general, if it wishes to buy and sell securities must trust a broker. On cash purchase transactions, for example, payment is due the broker four business days after purchase, even though the securities in the ordinary course of business will not be delivered to the customer for some time thereafter, as the seller, also, is not required to deliver his securities to his broker until the four days after the sale. Upon receipt of the seller's certificates, the broker must forward the certificate to the transfer agent and a new certificate must be issued.

With reference to margin accounts (both where the buyer borrows cash from his broker to make a purchase and where he is engaged in selling short), (see Special Study at Pt. 1, p. 389) the SEC noted additional hazards.[1] Concerning margin agreements, the Special Study declared (Pt. 1, pp. 390-91):

> Typically, margin agreements give the broker-dealer the following rights with respect to his customers' assets:

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[1] Plaintiffs recognize that during the period here in question, First Securities had no margin accounts. However, Ernst & Ernst and the AICPA have requested this Court to enunciate a rule of law which will apply throughout the industry. Thus this Court's decision will affect brokers which do a margin business.

1. All property, . . . which the broker-dealer may be holding for a customer, . . . is subject to a lien. . .

2. All such property held by the broker-dealer may be pledged, . . . without notice to the customer for the amount the customer owes the broker-dealer or for a greater or lesser amount. The broker-dealer need not retain in his possession a like amount of any securities or other property deposited.

3. . . . if the broker-dealer should deem it necessary for his own protection, the broker-dealer is authorized to sell any or all securities, . . . which is held for the account of the customer without notice to the customer, and without restriction as to market or conditions of sale.

• • •

Additionally, the customer is required to sign a separate loan consent that typically reads as follows:

> Until you receive written notice of revocation signed by the undersigned, you are hereby authorized to lend, to yourselves as broker or to others, any securities sold by you on margin for the account of, or under the control of the undersigned.
>
> The terms of the usual margin agreement are entirely for the benefit of the broker-dealer, . . .

The perils for the customer in this "one-sided" agreement (Pt. 1, p. 391) are evident. The broker under the agreement had complete authority, without notice to, much less the consent of, his customer to sell, lend or borrow against any security held by the broker for the customer. In the hands of an honest broker, this power is awesome. In the hands of a dishonest broker, this power can be disasterous.

Another peril noted by the SEC related to customers' free credit balances. Such balances, which consist of cash held by a broker which a customer may withdraw without restriction, amounted to staggering sums during the period of the Study. Thus, the 681 member firms of the New York Stock Exchange in January, 1962 held between $1.2 billion and $1.5 billion in free credit balances during 1961. One firm, Merrill Lynch, held in excess of $233 million in free credit balances as of May 26, 1961 (Special Study, Pt. 1 at 394). These balances provided a source of interest free loans to the broker and "there appear to be no restrictions, except in a few jurisdictions on the use of free credit balances for the purposes of the firm. All firms may use these balances to maintain positions in securities or otherwise in their general operations." Id. at 395. Thus, the customer who entrusted his money to a broker, either by making a deposit of money or by ordering securities sold on his behalf and not requesting payment of the proceeds, was, in effect, making an unsecured, interest free loan to his broker. His only security, at the time of the Special Study, was the honesty and solvency of his broker.

In 1964, the SEC required brokers to inform their customers that full credit balances may be used by the broker in its business, are not segregated and are payable on demand. It did so by adding Rule 15c3-2. 17 CFR §240.15c3-2. This rule, while technically applicable only to brokers dealing on over the counter securities actually applies to almost all brokers.

Noting the particular hazards to investors which accompany the brokers' freedom to utilize their customers' free credit balances, the SEC proposed, in 1941, that brokers be required to segregate these funds. The proposal was "vigorously opposed by the securities industry," and was not adopted. Special Study, Pt. 1, p. 400. See, also, *Report of SEC to the House of Representatives*

Committee on Interstate and Foreign Commerce, 77th Cong., 1st Sess. 29-32 (1941); 2 Loss, *Securities Regulation*, 1188-89.

In 1941, 1956 and 1959, the SEC proposed amendments to the securities acts which would have empowered it to issue rules requiring the segregation of securities held by brokers for customers, but the amendments were never adopted. Special Study, Pt. 1, p. 402. Consequently, as of 1963, brokers were not required by the securities acts to segregate customers' securities. A few stock exchanges, not including Midwest, required brokers to segregate fully paid securities held for customers from other securities held by the broker. Even the firms subject to those rules, however, were not required to specifically segregate the securities, but rather, could hold them in "street name" in bulk. The systems of segregation devised by the various brokers were not uniform and enforcement of the exchanges' rules was flexible. Special Study, Pt. 1, p. 403.

Finally, the regulations concerning hypothecation of customers' securities, as of 1963, "do not provide the public with complete protection." Special Study, Pt. 1, p. 405. While §8(c)(3) of the Exchange Act established a maximum hypothecation limit for all customers' securities, it placed no limitation upon the amount of any *single customer's* securities which could be so pledged. Thus, the securities of a single customer could be hypothecated to cover all of the broker's debts in margin accounts and this could be done without the consent of the customer. If the broker became bankrupt, serious difficulties were incurred by customers in retrieving their assets. Special Study, Pt. 1, §4.

Thus, the customers of a broker were, to an important extent, at the mercy of their "fiduciary," the broker. The peril to the investing public was grave.

C. The Key Role of the Audit Required by §17(a) and Rule 17a-5.

The federal statutes, as implemented by SEC rules, provided a network of protective devices designed to ameliorate the dangers to the public just described. Central among these devices are the record-keeping, auditing, and reporting requirements of §17(a) and Rule 17a-5.

Section 17(a), 15 U.S.C. §78q(a), requires every broker and dealer "to make, keep and preserve . . . such accounts . . . books and other records and to make such report, as the Commission by its rules and regulations may prescribe as necessary or appropriate in the public interest or for the protection of investors." Pursuant to the authority granted it by §17(a), the SEC has promulgated Rule 17a-5, 17 C.F.R. §240.17a-5 requiring every broker-dealer, with exceptions not here relevant, to file reports of financial condition containing information specified in Form X-17A-5 and requiring that those reports be "certified by a certified public accountant or a public accountant who shall be in fact independent."

Rule 17a-5(g) requires that the accountant's certificate shall identify without detailed enumeration the items of the report covered by the certificate and that it shall contain a reasonably comprehensive statement as to the scope of the audit made, including a statement as to whether the accountant reviewed the procedures followed for safeguarding the securities of customers. Further, the certificate must state "whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances and shall state whether the audit omitted any procedure deemed necessary by the accountant under the circumstances of the particular case." Paragraph (g) concludes with the warning "Nothing in this rule shall be construed to imply authority for

the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required by paragraph (h) of this rule."

Paragraph (h) states "The accountant's certificate shall state clearly the opinion of the accountant with respect to the financial statement covered by the certificate and the accounting principles and practices reflected therein." Finally, paragraph (i) warns "Any matters to which the accountant takes exception shall be clearly identified; the exception thereto shall be specifically and clearly stated; and to the extent practicable, the effect of each such exception on the related item of the report shall be given."

Plaintiffs stress §17(a) and Rule 17a-5 because some other statutory and regulatory devices to ameliorate the problems sketched above (a) are less effective in meeting the problems of broker solvency or reliability, others (b) do not deal with these problems, while still others (c) depend for their effectiveness on §17(a) and Rule 17a-5.

An example of (a): As noted by the Special Study, Pt. 1, p. 68 et seq., each of the exchanges and the National Association of Securities Dealers ("NASD") require certain financial and other prerequisites for entry into the brokerage business. This regulation "is broad in coverage but creates only low barriers." Special Study, Pt. 1, p. 68. More importantly, these restrictions have little effect once a broker is registered and has gained admission to an exchange and the NASD. Thus, they serve primarily to prevent entry of those few persons who have past criminal records or are, at the time of application, financially unstable. Another protective device is the criminal penalty. (See §32 of the 1934 Act, 15 U.S.C. §78ff). These penal-

ties, per se, do not assist the victims of the criminal, and operate primarily as a deterrent. They did not deter Nay.

An example of (b): If a broker does go bankrupt, his customers formerly received some preference as general creditors under §60(e) of the Bankruptcy Act, 11 U.S.C. §96(e). Today the equivalent statute is 15 U.S.C. §78fff (c). But these statutes as a practical matter are of little help. Recovery is limited by the assets of the bankrupt broker; even preferred creditors may not receive full payment. As to its application in the case at bar, see *SEC* v. *First Securities Co. of Chicago,* 507 F.2d 417 (7th Cir. 1974). The plaintiffs here were not aided but suffered drastically through §60(e) application.

Examples of (c): The investigatory powers of the SEC accorded by §21 of the 1934 Act, 15 U.S.C. § 78u are strengthened by §17(a) and Rule 17a-5. Similarly, they render more effective the powers accorded stock exchanges and national securities associations to promulgate and enforce financial responsibility rules. (See §§6 and 15A of the 1934 Act, 15 U.S.C. §§ 78f and o-3).

The general proscriptive provisions of the Securities Acts against fraudulent conduct are not self-enforcing, but depend upon the vigilance of regulatory bodies and the possibility of civil damages through private enforcement to have effect. See, *J. I. Case Co.* v. *Borak,* 377 U.S. 246, 12 L.ed. 2d 423 (1964). In this area, too, §17(a) and Rule 17a-5 help insure the maintenance of necessary records.

Important as was the audit function during the period here at bar, its significance has since not decreased. The securities industry experienced one of its greatest disas-

ters in 1969 and 1970.[1] Scores of brokers, many large and long established, failed. The special trust funds established by the New York Stock Exchange and other exchanges were overstrained. To restore customer confidence in the industry, and as disaster threatened, Congress, in an atmosphere of crisis[2] enacted the Securities Investor Protection Act ("SIPA"), 15 U.S.C. §§78aaa et seq. This statute established an agency similar to the FDIC and the FSLIC to provide insurance against losses to customers of brokers. The insurance, however, is limited to $20,000 for cash losses and $50,000 for all losses incurred by any individual customer. 15 U.S.C. §78fff(f)(1). It does not prevent fraud and may only partially reimburse victims.

In order to remedy some of the ills pointed out in the 1963 Special Study, many of which became frightfully apparent in 1969-70, Congress by the SIPA amended §15(c)(3) of the Securities Exchange Act, 15 U.S.C. §78o(c)(3), to require SEC rules providing safeguards with respect to "financial responsibility and related practices of brokers and dealers, including, but not limited to, the acceptance and custody and use of customer's securities, and the carrying and use of customers' deposits or credit balances. Such rules and regulations shall require the maintenance of reserves with respect to customers' deposits or credit balances . . . ." The amendment, technically applicable

[1] For a concurrent discussion of the failures in the industry, see LXXXII *Fortune,* (Dec. 1970) 62 et seq.; LXXVI *Newsweek* (11/30/70) 71 et seq.

[2] See Report of the Subcommittee on Securities of the Committee on Banking, Sen. Doc. 93-13 (93rd Cong., 1st Sess., 1973); Gates, The Securities Investor Protection Act of 1970: A New Federal Role in Investor Protection, 1972 Sec. L. Rev. 706 (1972).

only to brokers registered to do business over the counter, in fact affects almost all brokers.

Pursuant to amended §15(c)(3), the SEC has mandated reserves against free credit balances. Rule 15c 3-3, 17 C.F.R. §240.15c3-3.

On June 26, 1975 the SEC adopted, effective Sept. 1, 1975 a uniform net capital rule for all brokers. The new rule replaces the varying rules of the exchanges, and also provides an alternate approach for determining capital adequacy. SEC Exchange Act Release 11497, CCH Sec. L. Reptr. Par. 80,212.

Only last June 4, the President signed the Securities Reform Act of 1975, PL 94-29. This act, *inter alia,* expanded the coverage of the 1934 Act to include municipal securities dealers, and similarly broadened the scope of §17(a) to include them within its record keeping, auditing and reporting provisions. Under new §17(e), registered brokers and dealers annually must send customers a certified balance sheet and other financial information as the SEC prescribes (CCH Sec. L. Reptr. Par. 1170).

These new requirements impose additional regulations on brokers, whose observance is capable of verification by audit. Plaintiffs do not suggest that such verification necessarily is now part of the audit function. But plaintiffs do call attention to the fact that from time to time in the past, the SEC has seen fit to tighten enforcement of regulations by specifically imposing additional audit requirements. Consider, for example, the Instructions to Form X-17A-5 as in force during the audit period (pp. 5-8 above), and as in force shortly thereafter (App. 166). Currently the auditor is required specifically (Item 8, App. 167) to

verify the net capital ratio. The ruling sought here by Ernst & Ernst, insofar as it would restrict its §10(b) and Rule 10b-5 liability, would also undermine the effectiveness of SEC Rule 17a-5 and with it a vitally needed check on broker adherence to SEC regulations. This is a price the investing public should not be asked to pay.

Ernst & Ernst contends that because it has no financial interest in the firm it audits, it should not be held liable for damages to investors arising from its failure to expose wrongdoing. But as noted by the Court of Appeals for the Second Circuit with regard to attorneys,

> We do not find persuasive the argument by one recent commentator that since 'the alleged aider and abettor will merely be engaging in customary business activities, such as . . . preparing financial statements . . . [a requirement that he] investigate the ultimate activities of the party whom he is assisting [may impose] a burden upon business activities that is too great.' . . . The public trust demands more of its legal advisors than 'customary' activities which prove to be careless.

SEC v. *Spectrum Ltd.*, 489 F.2d 535, 542 (2d Cir. 1973). See also, *Drake* v. *Thor Power Tool Co.*, 282 F.Supp. 94, 104 (N.D. Ill. 1967):

> . . . the defendants have set themselves up to be independent certified public auditors. As such, they have assumed a peculiar relationship with the investing public. As accountants, the defendant clearly cannot be immunized from suit . . . Defendant . . . in independently auditing Thor's financial statements, remains liable regardless of whether it had benefited from the supposedly inflated market price. The position of an independent auditor is different from that of other corporate insiders.

The Seventh Circuit relied on §17(a), Form X-17A-5 and the mail rule violation. Yet Ernst & Ernst has the temerity to suggest (E.&E. Br. 33, note) that this statute and Rule are not raised by the petition for certiorari. Ernst & Ernst refers to Rule 17a-5, moreover, simply as a record-keeping provision. The Rule does, to be sure, require the keeping of records, but it requires also the audit, the certification of the audit, and a filing with the SEC. It is these provisions of the Rule that were relied on by the Seventh Circuit. The AICPA does not even discuss the statute and Rule, contenting itself with a passing mention of Form X-17A-5 (AICPA Br. p.42, n.40).

Ernst & Ernst engages in one final ploy to slough off its §17(a) and Rule 17a-5 responsibilities: it admits that implied civil liabilities flow from §10(b) and Rule 10b-5 (E.&E. Br.33, note). This it had to do, in the face of this Court's decision in *J. I. Case Co.* v. *Borak*, 377 U.S. 426 (1964) relating to §14(a) proxy violations. It does *not* argue that it owed no duty to the escrow claimants (E.&E. Br.31). But then it tries to brush aside implied liability under §17(a) and Rule 17a-5 on the specious ground that §§10(b) and 14(a) and the rules thereunder refer to wrongful activity (E.&E. Br. 34). There are non sequiturs in this approach: first, Ernst & Ernst is charged as an aider and abettor of §10(b) and Rule 10b-5 wrongdoing. It admits that implied civil liability flows from this section and rule. Insofar as Ernst & Ernst liability rests on §17(a) and its rule, it fares no better. The rationale for implied liability enunciated by this Court in *Case* v. *Borak*, 377 U.S. at 432-3, does not rest on the fact that conduct is unlawful. Rather, this Court speaks of the need to imply the availability of judicial relief for the protection of investors and the importance of private actions as an adjunct to SEC enforcement proceedings. But if illegality is the

touchstone, then that element is present. As Ernst & Ernst points out, pp. 58-9, the SEC may enjoin accountants, or discipline them for failure to meet appropriate professional standards. Section 21(e) of the 1934 Act, 15 U.S.C. §78u(e), authorizes the SEC to seek to enjoin "any person" who "is engaged or is about to engage" in any "acts or practices that will constitute a violation" of the Act or "any rule or regulation thereunder." Surely a violation of Rule 17a-5 is such a violation, and supplies the element of unlawfulness and prohibition (cf. E.&E. Br.34, note) if any is needed.

D. The Four Audit Violations Charged to Ernst & Ernst as Violations of SEC Audit Instructions.

It remains only to demonstrate that each of the four audit violations charged against Ernst & Ernst may be found by the fact finder to be violations of Rule 17a-5 or the Instructions to SEC Form X-17A-5. The audit report must be filed on this form. The Instructions as of the audit period appear above, pp. 5-8.

The first violation charged is a failure to report the mail rule. According to the Instructions to Form X-17A-5 set out above, p. 6, "The audit shall substantiate the stated assets and liabilities as of the date of the financial questionnaire and the scope and the comprehensiveness thereof shall be such as would enable the independent public accountant to express an opinion as to the stated financial condition of the respondent as of that date." There follows a detailed listing of seven items to be included in the audit. The seventh item states categorically *"The independent public accountant shall review the methods of internal accounting control of the respondent* and its procedures for safeguarding securities." [Emphasis added]. Ernst &

Ernst recognized its responsibility to review First Securities' internal accounting controls. Thus, in its letter to First Securities accepting appointment as auditor for 1963 (Hooker Dep., Ex4), Ernst & Ernst stated,

> "Our audit report will state that our examination *included a review of the system of internal control* and the procedures for safeguarding securities . . ." (Emphasis added.)

Following completion of the audit, Ernst & Ernst prepared an "audit report" (Hooker Dep., Ex6) dated September 13, 1963, signed by Ernst & Ernst and addressed to the Board of Directors, First Securities Co. of Chicago. The accountant's report stated in part:

> We have examined the answers to financial questionnaire of First Securities Co. of Chicago as of August 30, 1963. Our examination was made in accordance with generally accepted auditing standards, and accordingly *included a review of the system of internal control* and the procedures for safeguarding securities and such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances . . . [Emphasis added.]

As to the mail rule, we have shown actual knowledge of the rule and a conflict of affidavits as to its impact on internal control. Thus the mail rule poses a jury issue. If the jury believes Mr. Mayer, the plaintiffs' expert, then Ernst & Ernst, having uncovered a deficiency in internal control, has a clear duty to take an exception in its certificate.

As to the second ground asserted, Ernst & Ernst itself in 1965 declared the First Securities internal controls "weak," and recommended significant improvements to

First Securities. The improvements were not adopted and yet Ernst & Ernst failed to note the facts in its certificate.

The third violation charged, the failure to investigate the collectibility of the indebtedness due from Nay, follows from the very first line of the X-17A-5 Instructions, to "substantiate the stated assets." (See. p. 6 above). It would be meaningless to require written confirmation of an officer's account (Item 5(f) of the Instruction) (p. 7 above) without requiring inquiry into collectibility.

The fourth violation, concealing the 1967 net capital violation, hardy needs comment. As to this, Ernst & Ernst was guilty of the filing of a false certificate.

E. The Negligence Liability Limitations Suggested by the SEC—Their Undesirability.

The SEC contends, correctly we assert, that an auditor is liable for its failure to conduct audits in accordance with generally accepted auditing standards, but suggests such liability be limited.

The SEC proposes that an auditor should be liable "only if (1) he knew or could reasonably foresee that his statement would induce the plaintiff to enter into the particular transaction which forms the basis of the suit, (2) the plaintiff relied upon the statement, and (3) the amount of the plaintiff's damage caused by the accountant's negligence is definite and ascertainable." (SEC Br.23).

With regard to the first standard, the SEC formulates a less restrictive limitation at page 32 of its brief. There, the SEC submits that liability should attach where "the [defendant] knew or had reason to believe that the plaintiff would rely upon his conduct." This formulation apparently does not require that the defendant knew "or could reasonably foresee" that plaintiff would be induced to engage "in the particular transaction" which forms the basis of the suit.

As the SEC itself recognizes, the question of damages apart from liability has not heretofore been at issue in this case. The parties have never expressed their views on the issue and the courts below have not passed upon it. The matter, therefore, seems to be outside the grant of certiorari. It is, moreover, raised prematurely since it is an issue better explored after trial on the merits.

Plaintiffs express no views as to the SEC position regarding an auditor's liability in connection with a prospectus or proxy statement. In connection with his liability for failure properly to conduct a broker audit, however, we submit that the SEC suggestions are undesirable. They would not serve to "promote enforcement of the Act and to deter negligence by providing a penalty for those who fail in their duties." *Globus* v. *Law Research Service, Inc.*, 418 F.2d 1276, 1288 (2d Cir. 1969).

Plaintiffs charge Ernst & Ernst with duties imposed upon it by §17(a) and Rule 17a-5. As discussed above, pp. 43-50, Rule 17a-5 is designed to protect all investors who have contacts with a broker. The audit provides general protection not related to specific transactions. Rather, it is designed to assure that all operations of the broker, and the broker's financial condition are such that customers will not be victimized or subjected to losses. As is indicated by the broker bankruptcies of 1969 and 1970, it is apparent that a brokerage house failure can have a ripple effect throughout the industry, endangering the solvency of other brokers and hence imperiling their clients.

Thus, the imposition of a high standard of conduct upon the auditor of a broker serves not only to protect the customers of the audited broker, but also the customers of other brokers. While plaintiffs do not contend that the auditor should be held liable for the ripple effect damages incurred by customers of other brokers, plaintiffs submit that their protection, as well as that of the customers of the broker being audited, requires that auditors be liable for losses resulting from their violation of generally acepted auditing standards.

The first SEC criterion is that the defendant must know or foresee that the financial statement would induce the plaintiff to engage in the particular transaction involved in the suit. Where an auditor prepares an audited financial statement for a prospective issuer of new securities, it is clear that the public will rely upon the audited statements.

The audit of a broker, however, unlike an audit of an issuer of securities, is not intended primarily to provide information to investors. Rather, it is intended for the protection of investors from financially unsound or unscrupulous brokers. The special hazards to the investing public outlined above emphasize the need for such protections.

The failure of the auditor to comply with generally accepted auditing principles does not, and cannot, therefore affect only a single "particular transaction." Rather, it allows unsound or illegal practices to infect all the dealings of the broker in question.

The audit of a broker is essentially a regulatory audit. It does not relate to a "particular transaction." Public reliance is generalized and derivative, not specific and direct.

Based upon the audit (and, of course, other information) the SEC may decide to investigate a broker, institute legal action against it, or otherwise proceed. The investing public in turn, relies on the SEC for enforcement of the federal statutes. It assumes investigation and regulation.

It cannot well be otherwise. The investing public (other than a few very large investors) simply lack the time, the money, and auditing skills to determine whether a broker is solvent and whether it is obeying the law.

If the SEC intends, as it indicates at page 32 of its brief, that plaintiffs need only establish that Ernst & Ernst knew or had reason to believe they would rely on its conduct in making the audit, plaintiffs submit that the record establishes such knowledge. Ernst & Ernst knew that it was conducting an audit required by statute to assure the solvency and integrity of First Securities. It knew, or had reason to know, that if its audit disclosed irregularities, the SEC and other regulatory authorities would investigate such irregularities. It also knew that its issuance of a clean certificate would induce the SEC, Midwest, and the NASD to continue to hold First Securities out as a broker in good standing and that, therefore, First Securities would continue to receive the patronage of its customers. Where, as here, an audit is designed to provide information to regulatory authorities whose function is to protect the public interest, the auditor must know that the investing public will rely upon the results of the audit as their principal means of determining whether a broker is solvent and honest. Thus Ernst & Ernst could reasonably foresee that its failure to conduct its audit in accordance with generally accepted auditing standards could result in injury to any person dealing with First Securities.

The second limitation on liability suggested by the SEC requires that the plaintiffs, in fact, rely upon the statements made by the auditor. This standard, too, is inapplicable to a broker audit. The broker-audited financial statement is not intended primarily for the public. The truth of this proposition is evident in the fact that while the audit requirement has been in force for decades, only recently have brokers mailed balance sheets to their customers. True, a customer could examine the report to the SEC at an SEC office. But the general public was t expected to take such action.

Finally, the SEC maintains that the damages arising from Ernst & Ernst's failure to comply with generally accepted auditing principles must be "definite and ascertainable." The approach of the SEC to this requirement involves the same defect of analysis as that discussed above. Where an auditor conducts an audit of a broker, its purpose is not to provide information usable in any particular transaction. Its true purpose is to assure the public that it is safe to deal with the broker in any transaction. A clean audit certificate, in effect, informs the regulatory authorities, and thereby, all the customers of the broker that the auditor, having complied with generally accepted auditing standards, has found that the broker is solvent and that the broker's practices provide adequate safeguards against dishonesty.

There is the further consideration that the plaintiffs here charge Ernst & Ernst with a failure to report weaknesses in internal control known to it. Once internal controls are known to be weak, the books of the broker can no longer be relied upon. What is more, the broker may be subject to embezzlements or thefts. Officers or employees may be using the broker as a cover for frauds. Precisely these things occurred in the case at bar.

The statutory analogies advanced by the SEC (SEC Br. 25-33) fail to support its standards: we may set to one side the absolute liability sections as plaintiffs are not contending for absolute liability (Section 12(1) of the 1933 Act, 15 U.S.C. §77l(1); §11 of the 1933 Act, 15 U.S.C. §77k and §16(b) of the 1934 Act, 15 U.S.C. §78p(b)).

In the remaining statutes cited by the SEC (pp. 26 et seq.), liability as to certain defendants is limited to a negligence standard. In some cases the burden presumably is on the plaintiff to prove negligence; in other cases, the defendant must prove his freedom from negligence. Thus, as the SEC frames the issues with respect to §11(b)(3) of the 1933 Act, 15 U.S.C. §77k(b)(3), certain participants in a securities distribution have "a duty of care to discover" (SEC Br.26) untrue statements and omissions in registration statements.

Plaintiffs asert no more with respect to Ernst & Ernst and its audits of First Securities.

There is no suggestion in the various provisions cited by the SEC that once the statutory standard for liability had been met (or the statutory defense of "good faith" rejected), that damages should be limited by hurdles not imposed by Congress. Quite the contrary, once liability is determined, damages should be computed in accordance with standards otherwise generally applied.

Liability limitation here seems particularly inappropriate since it is clear on the record that in connection with each of the four auditing violations charged against Ernst & Ernst, Ernst & Ernst had actual knowledge of the facts: it knew of the mail practice, Ernst & Ernst itself noted other internal control weaknesses, it knew of Nay's large debt to First Securities, and it deliberately failed to take exception to the net capital violation.

Ernst & Ernst expressly disclaims a contention that it owed no duty to plaintiffs (E.&E. Br.31). The SEC (SEC Br.20-22) acknowledges that the facts at bar support an aiding and abetting claim under Rule 10b-5, stating that, ". . . its alleged negligence in failing to report upon an alleged deficiency in First Securities system of internal controls would constitute a misstatement or an omission to state a material fact necessary to make the statements made not misleading in connection with Nay's and the respondents' respective sales and purchases of securities." (SEC Br.21). Moreover, the SEC adds (SEC Br.21-22),

> In addition, any requirement that aiders and abettors must have knowledge of the independent wrong committed by another is satisfied when the aider and abettor has breached a duty of inquiry and would have acquired knowledge of the independent wrong if the duty of inquiry had been fulfilled. The court of appeals held that Ernst & Ernst had both a common law duty of inquiry resulting from its contractual arrangement with First Securities and a statutory duty of inquiry imposed by Section 17(a) of the Securities Exchange Act and Rule 17a-5 thereunder (Pet. App. 5a-6a). Assuming that Ernst & Ernst would have acquired knowledge of Nay's mail rule if it had fulfilled its duty of inquiry, the breach of that duty, whether negligent or willful, facilitated Nay's fraud.

The SEC adds a footnote reference to ALI *Restatement of Torts,* §876(c) supporting its position under the general law of torts, and a reference to *Brennan* v. *Midwestern United Life Insurance Co.,* 417 F.2d 147, 154 (7th Cir. 1969), *cert. denied* 397 U.S. 989 (1970), to the effect that if relevant facts had been disclosed by Ernst & Ernst to regulatory agencies there is a presumption the "appropriate regulatory action would have been taken." In light of the foregoing sound principles, plaintiffs are at a loss to understand the SEC argument at pages 34-36 which seems to imply that Ernst & Ernst owed plaintiffs no duty under §10(b) and Rule 10b-5. Yet the SEC recognizes that the Ernst & Ernst certification "at most facilitated Nay's concealment of his fraudulent activity, and thus avoided detection and correction by regulatory authority." (SEC Br.34-35). No further nexus (cf. SEC Br.35) is necessary.

As to SEC note 25 at page 35 regarding the scope of the Ernst & Ernst duty under §17(a) and Rule 17a-5: Ernst & Ernst owed a duty to the plaintiffs under those provisions just as it would a duty under §10(b) and Rule 10b-5. Ernst & Ernst itself does not claim to the contrary. Its footnote on §17(a) and Rule 17a-5 (E.&E. Br.33-34) mentions the word "duty" but in the context that no civil liability may be implied from these provisions. This plaintiffs have shown above (pp. 43-50) is fallacious. Ernst & Ernst does not argue that plaintiffs were not "customers" of First Securities as a basis for attempting to deny to plaintiffs protection under §17(a) and Rule 17a-5.

Finally, the SEC view of the term "customer" seems constricted. Under the SEC view, if plaintiffs were customers of First Securities both §10(b) and §17(a) duties would flow to them from Ernst & Ernst. Yet here, the Seventh Circuit upheld plaintiffs' claims as claims in the First Securities receivership case, *SEC* v. *First Securities Co. of Chicago,* 463 F.2d 981 (1972), *cert. denied* 409 U.S. 880 (1972). It pointed out that plaintiffs had been "brokerage clients of First Securities, buying and selling securities through First Securities in regular fashion." 463 F.2d at 983. Nay recommended the escrow to all plaintiffs but one when plaintiffs were at the First Securities offices.

Plaintiffs sold their legitimate securities through First Securities to obtain cash for their escrow investments. The Seventh Circuit held that First Securities was liable to plaintiffs as a "controlling person" of Nay under §20(a) of the 1934 Act, 15 U.S.C. §78t(a) and as an aider and abettor under §10(b). 463 F.2d at 986.[1] First Securities was the cloak and cover for Nay's fraud; Ernst & Ernst was entrusted with the task of auditing the cloak and cover; because of its failures, Nay's frauds were never unmasked. The case for Ernst & Ernst's liability is clear.

III.

EVEN IF THIS COURT DETERMINES THE APPLICABLE STANDARD TO EMBODY "RECKLESSNESS" OR "SCIENTER," GENUINE ISSUES OF MATERIAL FACT PRECLUDE SUMMARY JUDGMENT.

Plaintiffs have contended, supra, pp. 19-34, that the Court of Appeals correctly held that genuine issues of fact exist as to whether Ernst & Ernst violated its statutory duty to comply with generally accepted auditing standards in conducting its audits of First Securities from 1946 to 1968. Both plaintiffs and the SEC (SEC Br. 10-22) submit that such violations of generally accepted auditing standards are sufficient for liability under §10(b) and Rule 10b-5. Ernst & Ernst and the AICPA, however, contend that an auditor may be found liable only if he acts with "scienter" in aiding or abetting the fraud of a broker. If this Court adopts such a standard, plaintiffs submit that there is sufficient evidence in the record

[1] The case cited by the SEC at page 34, note 24 holds simply that plaintiffs were not customers under a Bankruptcy Act provision applied by analogy in the equity receivership case.

from which "scienter" may be inferred and that, therefore, a genuine issue of fact exists to preclude summary judgment.

A. "Scienter" Requires Only That the Defendant Know of the Falsity of His Statements or Act in Reckless Disregard of the True Facts.

Ernst & Ernst and the AICPA formulate varying definitions of "scienter." The AICPA submits that "scienter" exists where the evidence demonstrates an "intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme or artifice to defraud." (AICPA Br. 10). Ernst & Ernst would further limit the liability of auditors. It defines "scienter" (E.&E. Br. 31) as "actual knowledge or reckless or willful disregard of fraudulent conduct," in other words, "knowledge or willful or reckless disregard of Nay's fraudulent conduct." (E.&E. Br. 31). Plaintiffs submit that these definitions impose a standard of proof unknown to securities regulation and, if adopted, would immunize auditors from liability, even in the face of egregious conduct.

As early as 1916, this Court, in dealing with the liability of bank directors for misstatements made in reports to the Comptroller of the Currency required by the National Bank Act, established the requisites of "scienter" for a violation of that statute. In *Jones National Bank* v. *Yates*, 240 U.S. 541, 60 L.ed 788 (1916), depositors in an insolvent bank sued its directors for damages arising from false statements made in reports to the Comptroller of the Currency. The plaintiffs based their complaint upon the National Bank Act which provided that liability would attach only where misstatements were "knowingly" made. The defendant directors asserted nonliability because they were unaware of defalcations committed by officers of the bank.

This Court rejected that contention, holding that where the making of a false report is a violation of the statute, the directors are liable if the evidence showed the directors had knowledge of the falsity of the reports or showed such "reckless disregard of the truth or falsity of their contents as would show that the participation in, or the assent to the violation of the statute was 'in effect intentional'" (240 U.S. at 560). This Court concluded that defendants were properly held liable, for

> Assuming that they were ignorant of the frauds that had been committed and concealed by falsified entries, there was warrant for the conclusion that they could not have failed to acquire sufficient information to be aware that the representations in the official reports . . . were materially false and calculated to deceive. Id. at 563.

In *Bowerman* v. *Hamner,* 250 U.S. 504, 63 L.ed. 1113 (1919) this Court again dealt with the requirement of "scienter" under the National Bank Act. In that case, the bank's officers had made loans in violation of the rules and regulations of the appropriate regulatory authorities. When the bank failed, the depositors sued the directors, who defended on the basis that they were unaware that the loans had been made in violation of the rules. This Court held the directors liable stating that they should not "be permitted to be shielded from liability because of want of knowledge of wrongdoing, if that ignorance is the result of gross inattention." 250 U.S. at 512. Thus, this Court established that under the National Bank Act, liability for "knowing" violations could be grounded upon defendants' knowledge that required reports were false or upon their reckless disregard of the truth or falsity of those reports, even where they were entirely unaware of frauds committed by bank officers.

A similar definition of "scienter" as knowledge of the falsity of required reports or reckless disregard for their truth or falsity has been applied in both criminal and disciplinary proceedings arising under the Securities Acts. In *Stone* v. *United States,* 113 F.2d 70 (6th Cir. 1940), defendants were convicted of mail fraud and of criminal securities fraud in the sale of stock in a failing corporation. Defendants alleged that they had relied upon information provided them by others and that, therefore, they did not possess the requisite degree of "scienter" in violating the act. The Court of Appeals, noting the long-standing principle that "whatever result reasonably flows from an act is presumed to have been intended by the person who did it," sustained defendants' convictions. It further held

> ignorance of facts set up as a defense is unavailing where the defendant, by the exercise of due diligence could have become aware of his mistakes, especially where others may suffer loss by his misstatements . . . where guilty knowledge is an element in the offense . . . actual knowledge is not required, it may be inferred. Scienter may be inferred where the lack of knowledge consists of ignorance of facts which any ordinary person under similar circumstances should have known. 113 F.2d at 75.

A similar standard was applied in *Barnett* v. *United States,* 319 F.2d 340 (8th Cir. 1963), a case involving the revocation of a broker's registration by the SEC. Barnett alleged that he had merely passed information to his clients which had been supplied him by another person. The court refused to recognize such a defense to revocation of registration because "a dealer cannot close his eyes to obvious facts and come into court claiming lack of knowledge." 319 F.2d at 340.

In two cases in recent years, the Second Circuit has enunciated the principles upon which it determines when

the requisite scienter for a criminal conviction or for revocation of registration exists. In *United States* v. *Benjamin,* 328 F.2d 854 (2nd Cir. 1964), a criminal proceeding, the defendant, an accountant, asserted that he did not have the necessary *mens rea* to sustain a criminal conviction. The Court of Appeals rejected this contention:

> Congress . . . could not have intended that men holding themselves out as members of these ancient professions [attorney and auditor] should be able to escape criminal liability on a plea of ignorance when they have shut their eyes to what was plainly to be seen or have represented a knowledge they knew they did not possess. 328 F.2d at 863.

Therefore, a criminal conviction may be sustained if "defendant deliberately closed his eyes to facts he had a duty to see . . . or recklessly stated as facts things of which he was ignorant." Id. at 862.

More recently, the Second Circuit sustained the revocation of a broker's registration by the SEC on the basis that the facts known to the broker "were more than sufficient to put the petitioners on notice that something was wrong. Under such circumstances they were under a duty to investigate and their violation of that duty brings them within the term 'wilfull'." *Dlugash* v. *Securities and Exchange Commission,* 373 F.2d 107, 109 (2d Cir. 1967). Thus, it established that even in criminal prosecutions or disciplinary proceedings, actual knowledge of the fraud involved is not required to be shown. Rather, the requisite degree of culpability is proved where defendant is aware of facts which put him on notice that a fraud may exist and, nonetheless, disregards his knowledge of those facts or recklessly states as facts matters which he knows to be untrue or of which he has no knowledge. Plaintiffs

submit that if a criminal conviction for securities fraud may be grounded upon evidence of such degree of "scienter," civil liability, if it requires scienter, cannot require proof of any greater degree of culpability.

The cases above recognize that the auditor plays a pivotal role in the regulation of securities brokers and that his failure to report or investigate discovered irregularities serves to frustrate the statutory scheme designed for the protection of investors. Additionally, they recognize that the auditor, who has a "peculiar relationship with the investing public," *Drake* v. *Thor Power Tool Co.,* 282 F.Supp. 94, 104 (N.D. Ill. 1967) may not close his eyes to the facts which, in the exercise of due diligence, he would recognize as "danger signals" indicating that fraud may exist. See, *Elbel* v. *United States,* 364 F.2d 127 (10th Cir. 1966). Thus, they establish that an auditor, whether or not he intends to cause injury to any investor[1] or derives any benefit from a fraud[2] is liable for violating its statutory duties to see all that it is required to see, to report as facts only true facts and to refrain from stating as fact that which it does not know to be fact.

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[1] See, *Securities and Exchange Commission* v. *Capital Gains Research Bureau,* 375 U.S. 180, 192 n.39, 11 L.ed.2d 237 (1963):

> Even in a damage suit between parties to an arms length transaction, the intent which must be established need not be an intent to cause injury to the client . . . it is not necessary that the person making the misrepresentations intend to cause loss to the other or gain a profit for himself.

[2] See, *Drake* v. *Thor Power Tool Co., supra* at 104:

> Defendant, Peat, Marwick, in independently auditing Thor's financial statements remains liable regardless of whether it had benefiitted [from the fraud].

B. The Record Discloses Genuine Issues of Material Fact as to Whether Ernst & Ernst Acted Recklessly or With "Scienter."

Determinations of whether a defendant possessed requisite knowledge, or acted with intent or in reckless disregard of facts "are seldom made on the basis of direct proof. More often they are arrived at by inference from indirect evidence after the trier of fact has judged the credibility of the witnesses." *Brennan* v. *Midwestern United Life Ins. Co.*, 417 F.2d 147, 149 (7th Cir. 1969); *United States* v. *Vasen*, 222 F.2d 3 (7th Cir. 1955). In the case at bar, the trier of fact has not yet heard the evidence and has had no opportunity to make such determinations. Plaintiffs submit that the record, as it stands, establishes that there is a dispute of fact as to whether Ernst & Ernst acted recklessly or with scienter. Hence, even if this Court determines that reckless conduct or "scienter" is required, plaintiffs are entitled to a trial.

The facts have been set out extensively above in the statement of the case and the circumstances on the basis of which the trier of fact may infer reckless conduct or scienter have been spelled out in Part I (C) of the Argument, pp. 24-34 above. Plaintiff are entitled to a trial on the merits of their claims even if this Court holds that proof of recklessness or scienter to be an element of their claim.

IV.

FACT ISSUES PRECLUDE SUMMARY JUDGMENT AGAINST PLAINTIFFS ON THE BASIS OF EQUITABLE ESTOPPEL.

Although under some circumstances the doctrine of equitable estoppel may bar claims under Section 10(b) and Rule 10b-5, its application to each case depends on

the conduct of a specific party in the particular circumstances.

Plaintiffs' conduct furnished no reason for holding them equitably estopped, and neither the decisions on equitable estoppel nor the reasoning of the Court deciding them, support equitable estoppel in this case.

Plaintiffs will discuss the facts under section A and will comment on the authorities under section B.

A. Plaintiffs' conduct furnished no basis for holding them equitably estopped as a matter of law.

In this case (treating each husband and wife as one and the two Martin family members as one) there were twelve different persons who, from time to time and over a period of years, invested their money in interest-bearing securities on the advice of the president and prime mover of First Securities. There never has been a whisper that any one of the plaintiffs is other than honorable and scrupulous—one who would not overreach another. In a related case, the Court of Appeals described the plaintiffs (and others of Nay's victims) as "innocent investors" *SEC* v. *First Securities Co.*, 466 F.2d 1035, 1036 (7th Cir.) *Cert denied, sub nom Keith B. McKy* v. *Union Bank*, 409 U.S. 1041, 34 L.ed.2d 491 (1972). One element in the success of Nay's swindles was that his carefully selected victims were themselves of exemplary character and did not suspect evil in others.

Each plaintiff dealt with First Securities, an investment house whose president, Nay, was a member of the Midwest Stock Exchange. Plaintiffs did not seek to invest in speculative securities which promised to double or triple in market value—they sought only to purchase

interest bearing obligations. With a single exception each plaintiff was led to make an escrow investment in the offices of First Securities; each received acknowledgments on letterheads of First Securities, signed by its president, Nay.

These twelve persons acted independently of each other. At least some of the conduct which Ernst & Ernst relies on to claim estoppel of all of them was, then, conduct that each of these representative members of the investment public considered to be normal business practice.

Where twelve investors, completely disassociated from one another, all follow a similar pattern of conduct, it flies in the face of reason to contend that this pattern of conduct is one which an average reasonable investor would consider as a failure on his part to perform some duty cast on him by prudent investment practice or the law.

The plaintiffs were not oriented to the procedures of the market place. One had a PhD degree (physics, chemistry or mathematics); a second had a PhD degree (library science); a third had a PhD degree (courses not stated in the record); eight others had bachelor's degrees (architecture, philosophy, liberal arts, English literature, history, Latin, Greek). (Answers of plaintiffs to interrogatory #5 filed February 29, 1972). These backgrounds are rich in culture, impoverished in the hard routine of business.

Until they discovered the fraud many of the plaintiffs continued to do routine business with First Securities (Supplemental answers to Interrogatory #13 filed August 2, 1972); First Securities continued to be an ap-

parently successful brokerage firm; Nay continued to be its president and its member of the Midwest Stock Exchange; plaintiffs continued to receive interest on their escrow investments. What could there be in this continuing situation that should make these plaintiffs suspect that their securities were spurious?

To hold that an equitable estoppel was created by conduct prudently deemed appropriate by each member of this cross section of the investing public would create a formidable road block in the path of many innocent investors whom the Securities Acts are designed to protect. It would be tantamount to saying that if an investor is so completely duped that he does not suspect fraud and has no suspicion to report to anyone, then he is, by this very fact, estopped from some of the benefits intended by the Acts.

The entire program of investor protection; the Securities Exchange Act itself; regulated stock exchanges; auditing procedures; supervision by the Securities and Exchange Commission—all are designed to allay and do allay the concerns and fears of the investing public. Should it be said, then, that the plaintiffs are to be penalized because their confidence in the integrity of the securities industry and their confidence in the effectiveness of its regulation made them vulnerable to Nay's swindle, and deterred them from verifying the validity of their investments and the honesty of their brokerage firm? That, we submit, is no longer the burden of the investor. *Caveat emptor* has been replaced by a system which puts the burden on others, including brokerage firms and their auditors.

In part Ernst & Ernst rely, for an equitable estoppel, on the fact that some plaintiffs received requests for

verifications of their accounts and responded to them without mentioning the escrow investments. Hooker's affidavit listed and attached copies of thirteen such responses made by five of the plaintiffs. The argument that the plaintiffs to whom confirmations of account were sent "had a duty to inform petitioner [Ernst & Ernst] of their extra-record 'escrow' transactions * * *" (E & E Br. 87) virtually charges that the five plaintiffs' answers to the confirmations, absent some mention of the escrow investments, indicated a deliberate or reckless disregard of a duty to protect Ernst & Ernst and others and that they failed to give information which plaintiffs knew or should have known would have protected Ernst & Ernst and others.

The fallacy of this argument is that the audit requests, although they omitted the escrow investments, did not trigger the least suspicion in the minds of the plaintiffs themselves as to their investments. More than 60% of the $387,500. of escrow investments of the five plaintiffs were made *after* these plaintiffs had received and responded to the audit confirmation[1]. They would not have made such

[1] Two of the audit confirmaton answers of the Jacksons were dated December 31, 1961, prior to any Jackson escrow investment. Three more Jackson answers were dated December 31, 1962, after which the Jacksons made numerous escrow investments in 1963, 1964, 1965 and 1967 totalling $201,000. Supplemental Answers to Interrogatories filed August 2, 1972, Jackson answer to #39.

Mrs. Allison's answer to the confirmation request was made September 30, 1966, after which, in the years 1967 and 1968 she invested $26,000. Supplemental Answers to Interrogatories filed August 2, 1972, Allison answer to #40.

The first audit confirmation answer to Olga Hochfelder was made December 31, 1961, after which she invested $11,500. in 1963, 1964 and 1965. Supplemental Answers

investments if the audit confirmation requests had raised the slightest question in their minds that their accounts with First Securities were in other than perfect order.

The audit request form, moreover, stated that its purpose was to verify the position of the securities and the balance in the customer's account.

Each of these plaintiffs thought he had completed each escrow investment when he paid the consideration and received an acknowledgment on First Securities stationery signed by its president. Such acknowledgment was the equivalent of the delivery to him of a purchased security. He would not, therefore, expect to have a debit or credit balance or a long or short security position based on such transaction. More sophisticated investors than the plaintiffs might have concluded that the completed escrow account transactions were properly omitted from the confirmation record. The Court of Appeals held that whether the plaintiffs knew or reasonably should have known that they were to report the escrow accounts as exceptions on the confirmation requests is properly a question for the fact finder (Pet. for Cert., 31a, 32a).

Ernst & Ernst state that two of the elements of equitable estoppel are: "(a) knowledge, actual or constructive,

[1] (Continued)
to Interrogatories filed August 2, 1972, Hochfelder answer to #35.

Theresa W. Rothermel answered the audit confirmation on December 31, 1961, after which she invested $26,500. in 1962, 1963 and 1966. The record is not clear as to Mrs. Rothermel because she invested larger sums but received some repayments. However, she did invest $26,500 after returning the audit confirmation. Supplemental Answers to Interrogatories filed August 2, 1972, Rothermel answer to #35.

by the party to be estopped of the true facts; * * * (and) (c) justifiable reliance by the party claiming the estoppel upon the conduct of the party to be estopped, * * *" (E & E Br. 82).

The fact in this case is that Nay was embezzling money of First Securities customers; that there were no escrow investments; and that plaintiffs' money had been stolen promptly after each "investment" was made. These are the facts that plaintiffs did not know and of which they had no constructive knowledge.

Ernst & Ernst argues that it relied on plaintiffs' failure to disclose the true facts. Ernst & Ernst audited First Securities accounts each year commencing with 1946. In all these years it never performed its duty to inquire into Nay's abnormal mail rule, an inquiry which would surely have uncovered his embezzlements. Nay was indebted to First Securities at the time of each audit from 1958 through 1967. Ernst & Ernst never investigated the collectibility of this receivable. Had it done so it might well have discovered Nay's frauds. Most of the plaintiffs were caught in the embezzlement web long after 1946, long after Ernst & Ernst had annually breached its duty to investigate Nay's mail rule. Large portions of plaintiffs' investments in the escrow were made after Ernst & Ernst's failure to check the collectibility of Nay's growing debt to First Securities. Ernst & Ernst failed utterly to detect the Schueren swindles which began long before Ernst & Ernst began its audits and continued 21 years thereafter. How then can it be said Ernst & Ernst relied on representations of the plaintiffs as a justification for Ernst & Ernst's breach of its duty?

B. Prior decisions do not support the application of equitable estoppel in this case.

Ernst & Ernst cites *Royal Air Properties, Inc.* v. *Smith*, 312 F.2d 210 (9th Cir. 1962) but fails to discuss the second appeal in that case, at 333 F.2d 568 (9th Cir. 1964).

In the *Royal Air Properties* case plaintiff, claiming a right to recover under Section 10(b), proved a prima facie case for recovery. Defendant then sought to prove that after plaintiff made the securities purchase which he sought to rescind, he had served as a director of the defendant corporation, served as its president and attempted to purchase a controlling interest in the corporation. The trial court's refusal to permit this defense was reversed on the theory that in a proper case equitable estoppel should be available to prevent a plaintiff from postponing his suit while he determines, in the light of subsequent developments, whether his investment was more valuable than his cause of action. The Court said at pages 213, 214:

> The purpose of the Securities Exchange Act is to protect the innocent investor, not one who loses his innocence and then waits to see how his investment turns out before he decides to invoke the provisions of the Act. (Citing cases)

On remand the trial court heard the evidence and found that under all the circumstances, Smith's conduct was not such as to equitably estop him. In affirming this the Court of Appeals, 333 F.2d 568, 572, quoted with approval the statement of the District Judge that:

> The court believes now, as it did then, that he [the party against whom an estoppel was sought] was negligent—perhaps grossly so—in this regard, but

> such failure does not necessarily defeat his recovery here. He was exceedingly gullible in that he was over trusting, but this is understandable in view of the fact that his professional activities are wholly divorced from the world of business.

The doctrine of equitable estoppel and laches are devices by which the courts seek to overcome the obviously unfair action of an investor who marks time, with one eye on the possible increased market value of his investment and his other eye on the value of an action. *Dale* v. *Rosenfeld,* 229 F.2d 855 (2d Cir. 1956) made this point in holding estoppel to be a question for consideration by the fact finder on all the evidence.

Moran v. *Paine, Webber, Jackson & Curtis,* 389 F.2d 242 (3rd Cir. 1968), aff'g 279 F. Supp. 573 (W.D.Pa. 1967), has no application here. There plaintiff was barred by collateral estoppel. She had agreed to submit her already existing dispute to binding arbitration; the arbitration had been completed; she had exercised her arbitration review rights; and she was held barred by the arbitration award.

In *Straley* v. *Universal Uranium and Milling Corp.,* 289 F.2d 370 (9th Cir. 1962), the defense of laches was pleaded and judgment given for the defendant below. The Court of Appeals reversed, holding that laches was not a defense to a claim for a money judgment, since the defense of laches was equitable and the claim for a money judgment was an action at law.

Hecht v. *Harris, Upham & Co.,* 430 F.2d 1202 (9th Cir. 1970) gives more support to plaintiffs' position than to that of Ernst & Ernst. The plaintiff there claimed that defendant brokerage firm was liable to her because her account had been churned excessively and because her

quality securities had been converted to speculative securities. During the course of her investment dealings with the defendant firm, plaintiff had daily telephone contact with her customer representative. He had frequently come to her home in the evening and reviewed each purchase or sale with her. The Court held that the plaintiff had been fully informed of each purchase and sale and participated in or approved it. For that reason she was held equitably estopped from recovery on the grounds of the substitution of securities. Even on this ground the decision was based on the finding of the trier of fact after a full hearing of the evidence. On the churning question the Court recognized that plaintiff was fully aware of each of the many transactions. It held, however, that plaintiff, an unsophisticated investor, did not understand and was not chargeable with knowledge that the amount of activity in her account was excessive, and that she was, therefore, not estopped from recovery on the ground of churning. Plaintiffs submit that the reasoning of the Court that plaintiff in *Hecht* was not equitably estopped to complain of the churning precisely answers the argument of Ernst & Ernst that the twelve persons here ought to be estopped because five of them received confirmation slips which might mean different things to different unknowing investors.

Ernst & Ernst cites *Leather Manufacturers' National Bank* v. *Morgan,* 117 U.S. 96, 29 L.Ed. 811 (1886). There a depositor's clerk had altered checks and embezzled the depositor's funds. The bank tried to prove an equitable estoppel on the ground that it had mailed statements and cancelled checks to the depositor, who had received them without notifying the bank that they did not correctly reflect the checks drawn against the account. On this

issue the trial court directed a verdict for the plaintiff. This Court reversed with the statement quoted by Ernst & Ernst, which taken in itself might appear to hold that the depositor was estopped as a matter of law. The decision of the case, however, was to reverse and permit the fact finder to determining the validity of this defense, the court stating at page 122:

> "Whether the plaintiffs are estopped, by the negligence of their representative, to dispute the correctness of the account as rendered by the Bank from time to time is, in view of all the circumstances of this case, a mixed question of law and fact. As there is, under the evidence, fair ground for controversy as to whether the officers of the Bank exercised due caution before paying the altered checks, and whether the depositor omitted, to the injury of the Bank, to do what ordinary care and prudence required of him, it was not proper to withdraw the case from the jury."

Ernst & Ernst cites several other cases to support the estoppel argument but it is submitted that their application is limited to general principles of estoppel and laches under facts far removed from this case.

This case does not present a situation in which an auditor relied on an investor. It is a case in which investors relied on all of the protections they had been led to believe surround a regulated brokerage firm. Such protections included annual audits which, if faithfully and imaginatively carried out, would have flushed the swindler from the lair. His lair was the brokerage firm audited by Ernst & Ernst.

V.

PLAINTIFFS' CLAIMS SHOULD NOT BE BARRED BY LIMITATIONS

Plaintiffs argue in this section as follows:

A. The period of limitations as to plaintiffs' claims commenced with the discovery of the fraud in June, 1968, which is the earliest date on which they could reasonably have been expected to discover it.

B. As to some of the claims of some of the plaintiffs the limitation period would not have run even though there were no tolling of the limitation period.

A. The period of limitations as to plaintiffs' claims commenced with the discovery of the fraud in June, 1968, which is the earliest date on which they could reasonably have been expected to discover it.

There is substantial agreement among the parties as to the following: the action for civil damages under §10(b) was fashioned by the courts; there is no statutory period of limitations for these actions; the courts deemed it appropriate that the remedy it fashioned should not be open-ended; the courts borrowed limitation periods from state laws thus creating court imposed limitation periods on a court created remedy.

The differences between Ernst & Ernst and the plaintiffs revolve around the questions of (1) in 10(b) cases when does the limitation period commence? (2) to what extent have the courts reserved to themselves the power to relieve against the operation of the limitation period they have created? and (3) under what circumstances should the courts exercise their reserved power to toll the limitation period?

Narrowed to this case the question is whether the limitation period started at the time the plaintiffs discovered or ought to have discovered the fraud or at some earlier date. If at an earlier date should the limitation period be tolled until the plaintiffs discovered or ought to have discovered the fraud?

The solution to these questions is confused by a seeming diversity of comments by the courts. We suggest that this merits a brief overview of the problem.

Plaintiffs submit that the differences in the courts' statements reflect the diverse situations in which the courts have considered the limitation period questions—when the period starts to run and when it is tolled.

One type of case involves a suit against a sovereign under a statute in which the sovereign has permitted itself to be sued within a fixed time. Here the courts have no authority to extend the statutory period and the inquiry is directed to the interpretation of the statutory language granting and limiting the right to sue. Ernst & Ernst cites such cases although their application should be restricted to cases involving actions against a government. *Bryan* v. *United States,* 99 F.2d 549 (10th Cir.), *Cert denied* 305 U.S. 661, 83 L.ed 429 (1939), E & E Br. 102, 103; *Riley* v. *United States,* 212 F.2d 692 (4th Cir. 1954, E & E Br. 106.

Many cases dealing with the tolling of a limitation period consider a specific limitation period imposed by a federal statute which created the right and remedy.

This Court has held that the establishment of a time limitation on suit in the federal statute creating such right and remedy does not restrict the power of the federal courts to hold that the limitation period is tolled

under certain circumstances not inconsistent with the legislative purpose. *American Pipe & Construction Co.* v. *Utah,* 414 U.S. 538, 38 L.ed.2d 713 (1974).

The courts, however, are exacting as to the circumstances that are sufficient to toll the statute where its plain language establishes a specific limitation period.

One line of such cases are suits for treble damages under the Clayton Act.[1] The latitude of the Courts in these cases is restricted by the fact that the Congress has refused to amend this statute to provide for tolling the statute until discovery by the plaintiff of the facts giving rise to his claim. *Public Service Co.* v. *General Electric Co.,* 315 F.2d 306, 310 (10th Cir. 1963).

A review of the anti-trust cases relied on by Ernst & Ernst[2] explicates the circumstances required to toll a legislated limitations period. The tolling doctrine may be applied where the Court finds that even though Congress specifically barred actions, the circumstances of a particular case may justify the conclusion that the Congressional intent makes it an exception to the statutory rule.

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[1] 15 U.S.C. §15b "Any action to enforce any cause of action under sections 15 or 15a of this title shall be forever barred unless commenced within four years after the cause of action accrued."

[2] *American Pipe & Const. Co.* v. *Utah,* 414 U.S. 538, 38 L.ed.2d 713 (1974), E. & E. Br. 100, 101. *Detroit* v. *Grinnel Corp.,* 495 F.2d 448 (2d Cir. 1974), E. & E. Br. 103. *Akron Presform Mold Co.* v. *McNeil Corp.,* 496 F. 2d 230 (6th Cir.), *Cert. denied,* 419 U.S. 997, 42 L.ed.2d 270 (1974), E. & E. Br. 106, 111. *Moviecolor, Ltd.* v. *Eastman Kodak Co.,* 288 F.2d 80 (2d Cir. 1961), E. & E. Br. 106. *Public Service Co.* v. *General Electric Co.,* 315 F.2d 306 (10th Cir. 1963), E. & E. Br. 103.

As framed in *American Pipe & Construction Co.* v. *Utah,* 414 U.S. 538, 559, 38 L.ed.2d 713 (1974) the rule is:

> These cases fully support the conclusion that the mere fact that a federal statute providing for substantive liability also sets a time limitation upon the institution of suit does not restrict the power of the federal courts to hold that the statute of limitation is tolled under certain circumstances not inconsistent with the legislative purpose.

The use of the term "under certain circumstances" in this case establishes the intention of this Court to establish a flexible standard rather than imposing a straight jacket on the application of the doctrine of tolling.

Other cases have considered the equitable tolling of the limitation period in the context of statutes of limitations adopted by the legislature, and the language and holdings of those cases should be viewed in that light.

The leading and seminal case on the subject is *Bailey* v. *Glover,* 88 U.S. (21 Wall.) 342, 22 L.ed. 636 (1875). This case is cited as authority by both Ernst & Ernst (E. & E. Br. 100) and by other plaintiffs (Hochfelder Br. 31).

There, a bill in chancery, was filed to set aside conveyances of real estate fraudulently made by Benjamin Glover shortly before filing a bankruptcy petition. The bill alleged fraudulent concealment by the defendants, Glover's grantees. Glover was dead. The suit was brought against Glover's grantees more than two years after the appointment of the bankruptcy assignee. A demurrer to the bill was sustained on the basis of the two year bankruptcy statutory limitation.

On this record the only question necessary for decision was whether the statute of limitations should be

tolled in an equity proceeding where the defendants were guilty of fraud and fraudulent concealment and where the plaintiff, without his fault, was ignorant of the facts.

The Court held that on this record the statute of limitations should be tolled. The opinion added, however, that where a party is injured by fraud and remains in ignorance of the facts through no fault of his, the bar of the statute does not begin to run until the fraud is discovered even though there are no special circumstances or efforts by the party committing the fraud to conceal it from his knowledge.

Ernst & Ernst cite the following quotation from *Bailey* v. *Glover* as though it recited the only circumstances under which the statute of limitations can be tolled.

> To hold that by concealing a fraud, or by committing a fraud in a manner that it concealed itself until such time *as the party committing the fraud could plead the Statute of Limitations* to protect it, is to make the law which was designed to prevent fraud, the means by which it is made successful and secure (E. & E. Br. 100).

This language was clearly not a statement of the outside limits of the doctrine of tolling. It was a statement of the application of the doctrine to the facts before the Court. That the Court intended the principal of equitable tolling to be extended beyond those facts is evident from its statement at page 348.

> We also think that, in suits in equity, the decided weight of authority is in favor of the proposition that where the party injured by the fraud remains in ignorance of it without any fault or want of diligence or care on his part, the bar of the statute does not

> begin to run until the fraud is discovered, though there be no special circumstances or efforts on the part of the party committing the fraud to conceal it from the knowledge of the other party.

In the one hundred years since *Bailey* v. *Glover* the courts have extended its philosophy to situations in which equity is served by so doing.

We turn now to cases in which there is no statutory limitation and the courts are considering a limitation period they have imposed. Here we find the rule stated with great liberality in the interests of equitable relief to defrauded plaintiffs.

A milestone case is *Holmberg* v. *Armbrecht*, 327 U.S. 392, 90 L.Ed. 743 (1946).

Here a statute imposed liabilities on shareholders of Joint Stock Land Banks but enacted no limitation period. The Court borrowed a limitation period from state laws. The action was in equity and in holding the limitation period tolled Mr. Justice Frankfurter said at page 396:

> Traditionally and for good reasons, statutes of limitations are not controlling measures of equitable relief. Such statutes have been drawn upon by equity solely for the light they may shed in determining that which is decisive for the chancellor's intervention, namely, whether the plaintiff has inexcusably slept on his rights so as to make a decree against the defendant unfair.

Since that time Circuit Judge Judge Friendly in *Moviecolor Ltd.* v. *Eastman Kodak Co.*, 288 F.2d 80, 86 (2d Cir. 1961) held that the principle of equitable tolling of the limitation period applied in law as in equity. He interpreted the Court's references in *Holmberg* v. *Armbrecht*, to "equitable rights" to be the equivalent of references to "federally created rights".

This brings us to those cases dealing with the problem now before this Court, that is, a judicially created remedy to enforce a federally created right under § 10(b) and a judicially imposed limitation period.

In actions, as here, having their genesis in fraud, the important factor in tolling the limitation period is the time at which the injured party learned or should have learned of the true facts. It is because of plaintiffs' ignorance of the fraud that the courts in § 10(b) cases hold that the limitation period starts when the defrauded party learns or should have learned the facts.

Janigan v. *Taylor*, 344 F.2d 781, 784 (1st Cir. 1965) *Cert denied*, 382 U.S. 379, 15 L.ed.2d, 120 (1965) states:

> It is unnecessary to interpret the Act [referring to a Massachusetts limitation act] in order to toll the statute of limitations. Federal law has long been established, with more liberality than that of Massachusetts, that where fraud is involved the cause of action is, so-to-speak, automatically concealed, and does not arise until discovery.

Hooper v. *Mountain States Securities Corp.*, 282 F.2d 195, 206 (5th Cir. 1960) was an action by a bankruptcy trustee seeking relief for a violation of § 10(b) of the Securities Act. The two year bankruptcy limitation was pleaded but the Court said:

> But this is no insurmountable obstacle for we agree with Dabney v. Levy, 2 Cir., 1951, 191 F.2d 201, that the two year limitation prescribed in § 11 sub. e does not begin to run until the time the fraud reasonably should have been discovered.

Sargent v. *Genesco, Inc.*, 492 F.2d 750, 758 (5th Cir. 1974) states the rule:

> The federal securities laws contain no limitation period that is expressly applicable to claims under section 10(b) and rule 10b-5, nor does federal law prescribe any general statute of limitations for civil actions. Consequently, the limitation period which the forum state applies to the state remedy which bears the closest substantive resemblance to rule 10b-5 and which best effectuates its purpose is to be applied. (citing cases).
>
> However, the date when a claim accrues so as to trigger the state law limitation period is a matter of federal law, and our court-fashioned rule is that a 10b-5 claim accrues when the plaintiff actually discovers the alleged fraud. (citing cases).

Douglass v. *Glenn E. Hinton Investments, Inc.*, 440 F.2d 912, 914, 915 (9th Cir. 1971) was an action by a broker's customer against a securities salesman and his employer. One of the plaintiff's claims stated an action against the employer based on the 1934 Act § 20(a), 15 U.S.C. § 78t(a), dealing with controlling persons. Under this claim only vicarious liability was asserted against the employer who was not charged with direct fraud or concealment of plaintiff's cause of action. The case, thus, is very close to the case now before this Court on the facts that determine the application of a limitation period. The limitation period adopted by the Court was the three year state limitation period. More than three years had elapsed between the dates of the violations of §10(b) and the filing of the suit.

Both the trial court and the Court of Appeals held that the plaintiff could maintain her action. The Court of Appeals said at pages 914, 915:

> In Fratt v. Robinson, 203 F.2d 627 (9th Cir. 1953) this court adopted and applied Rem. Rev. Stat. §159 (4), now Wash. Rev. Code 4.16.080 (4) as the appropriate limitation statute with respect to section 10 (b) actions based upon transactions occurring in the State of Washington. This statute provides that an action for relief upon the ground of fraud must be brought within three years after it accrues. The cause of action is not deemed to have accrued, within the meaning of the statute, until the discovery by the aggrieved party of the facts constituting the fraud.

At page 916 the court stated:

> We are aware of no federal appellate decision in which the limitation period governing a section 10(b) action has been held to begin before the plaintiff reasonably could discover the violation of section 10(b) of the Act.

Vanderboom v. *Sexton*, 422 F.2d 1233 (8th Cir.) *cert. denied*, 400 U.S. 852, 27 L.Ed. 2d 90 (1970) was an action under SEC Rule 10b-5 against sellers of stock and others joined as aiders and abettors. The stock was purchased November 2, 1965. The suit was filed July 18, 1968. The District Court applied a two year limitation period based on a state statute and granted summary judgment in favor of all defendants, holding the claim barred by limitations.

The Court of Appeals reversed. As is often the case on summary judgment in complex cases the precise involvement of each defendant is not clear. The Complaint charged some of the defendants with fraudulent sale of stock and charged generally that other defendants "aided, abetted and conspired to defraud • •" the plaintiffs. There was, however, no reason for the Court of Appeals to differentiate between those defendants as to whom there was some showing of fraud on

the motion for summary judgment and those defendants whose involvement was as aiders and abettors without a showing of fraud. This distinction was irrelevant because the Court of Appeals held that the statute of limitations did not start to run until the plaintiffs knew or reasonably could have been expected to learn that they had been defrauded. Under this rule the discovery by plaintiffs that they had been defrauded started the limitation period alike against defendants guilty of fraud and those not guilty of fraud.

The Court said at page 1240:

> It is true that a 10b-5 claim is a legal action based upon an implied civil remedy in tort, Fishman v. Ratheon Mfg. Co., 188 F.2d 783 (2nd Cir. 1951), and even though the distinction between law and equity must be preserved in federal courts under Art. III § 2, clause 1 of the United States Constitution, there is no reason to differentiate as between the two kinds of actions in applying the federal policy as to the determining date on which a statute of limitations or laches begins to run. We feel that the remedial policy expressed by Congress in enacting the securities legislation would best be served by making any statute of limitations run only from the date of discovery of the fraud or from the date the fraud upon reasonable inquiry should have been discovered.

Parrent v. *Midwest Rug Mills, Inc.*, 455 F.2d 123, 128 (7th Cir. 1972) is a leading case for the application of the state statute of limitations in § 10(b) cases. The Court said:

> We must read into the three year limitation applied in the Rule 10b-5 count the 'equitable doctrine' that the statute does not begin to run until the fraud is discovered where a plaintiff injured by fraud remains in ignorance of it without any fault or want of diligence or care on his part. (citing cases).

Ernst & Ernst seek to impose on the authorities an additional requirement of "fraudulent concealment". The cases cited above do not support this position. Ernst & Ernst contends that the mere fact that a person is ignorant of his right to sue or of the facts out of which his right arises does not of itself prevent the running of a statute of limitations. (E. & E. Br. 106). None of the cases cited for this position is an action under § 10(b).

Ernst & Ernst develops a novel argument that the doctrine of fraudulent concealment was not devised to protect "innocent" plaintiffs, but to discourage fraud. (E. & E. Br. 106). It is a sufficient answer to this that the courts repeatedly refer to the doctrine, not as the doctrine of fraudulent concealment, as Ernst & Ernst dubs it, but as a doctrine of "equitable" tolling of the statute. "Equitable" to whom? Obviously to the persons who would suffer but for the application of this doctrine.

There has been no suggestion that any of the plaintiffs knew he had been defrauded, or knew the facts surrounding the spurious nature of his escrow investment prior to June, 1968, when Nay committed suicide.

There remains the question of whether the plaintiffs should have known they were being defrauded. With 17 different individual plaintiffs of various backgrounds, experience and varying contacts with Leston B. Nay and First Securities it is clear that such an issue cannot be decided as to these plaintiffs *en masse* on summary judgment procedure. Plaintiffs have discussed the reasons for the conclusion that they should not be charged with a failure to discover the fraud in the part of this brief dealing with equitable estoppel and submit that discussion as determinative of the similar question on the issue of limitations.

B. As to some of the claims of the plaintiffs the limitation period would not have run even if it commenced while they were ignorant of the fraud and had no means of learning of it.

Because the District Court held (Pet. for Cert. 36a) and Ernst & Ernst contends (E. & E. Br. 96, 97) that all of the claims of all of the plaintiffs were barred by limitations, it seems pertinent to point out that this holding and contention are incorrect even though there were no equitable doctrine of tolling.

The District Court held and Ernst & Ernst contends that the limitation period should commence from the date of Ernst & Ernst's last audit; in December 1967, the date on which the audit was completed and the report delivered. (Pet. for Cert. 16).

Even though no equitable doctrine of tolling applied plaintiffs submit that the limitation period should commence at a point of time related to some damage suffered by a plaintiff against whom it is sought.

If this were not true a defendant might fraudulently misrepresent a security to a potential investor who might act on the misrepresentation more than three years later. Would Ernst & Ernst then contend that the remedy of the defrauded investor was barred by limitations before his right to file an action came into existence?

This Court in *Zenith Radio Corp.* v. *Hazeltine Research*, 401 U.S. 321, 339, 28 L.ed.2d, 77 (1971) discussed the question of the beginning of a limitation period in an anti-trust case, as between the date of the commission of the act by the defendant and the date on which the plaintiff suffered an injury. This Court held that if the future damages flowing from the wrongful act were measurable and recoverable the limitation period commenced

to run at the date of the commission of the act, but if the future damages were not recoverable until sustained the limitation period commenced to run at the time the damage was suffered. At page 339 this Court said:

> In antitrust and treble-damage actions, refusal to award future profits as too speculative is equivalent to holding that no cause of action has yet accrued for any but those damages already suffered. In these instances, the cause of action for future damages, if they ever occur, will accrue only on the date they are suffered; thereafter the plaintiff may sue to recover them at any time within four years from the date they are inflicted.

No damage could be claimed by a plaintiff here for an escrow investment not yet made. It follows as to each plaintiff, that the earliest date on which a cause of action could accrue is the date on which he made his latest investment and as to some of these plaintiffs that was less than three years prior to the filing of this action.

Parrent v. *Midwest Rug Mills, Inc.*, 455 F. 2d 123, 128 (7th Cir. 1972) is frequently cited as establishing that the State Blue Sky Law limitation period will be used by the federal court as a convenient limitation period for actions under § 10(b) of the Securities Exchange Act. In that case the Court, without considering any other test stated that the time of the purchase was the point at which the limitation period commenced. The Court said:

> The next question is at what point does the Illinois three year limitation statute commence to run. The answer depends first upon whether the purchases of securities by plaintiffs were embraced in a 'total scheme' to sell securities to plaintiffs by fraudulent means at excessive prices, as contended by plaintiffs, or were independent transactions, as claimed by Boss. • • •

> Under Illinois securities law, a buyer has three years to sue 'not only from the date the right first accrues, but from the date the sale is completed'.

Plaintiffs urge that at the earliest the period of limitation as to each of them arose at the time he suffered damage. This might seem to be as to each plaintiff, the date of the last of his series of investments in the escrow. Even this would be a serious injustice to many of the plaintiffs. Ernst & Ernst audited First Securities each year from 1946 through 1967. There was no later audit of First Securities Company. During all of this time each escrow investor was sustaining a gradually increasing loss starting with the date of his first investment. The financial condition of Nay and First Securities deteriorated year after year as Nay's undiscovered embezzlements pyramided. It is sufficient to establish this to note that Nay's borrowings from First Securities Company increased from about $13,000. in 1958 to more than $48,000 in 1967 (*Supra*, 13).

However, if we direct our attention to the dates on which each plaintiff made the last of his series of investments we find that Helen Allison made an investment in the escrow on March 29, 1968, less than three years prior to the filing of this suit on February 11, 1971; Anna L. Jesse made an investment in the escrow on March 20, 1968, less than three years prior to the filing of this suit.[1]

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[1] Supplemental Answers to Interrogatories filed August 2, 1972. Allison answer to #40; Anna L. Jesse Answer to #35.

It can reasonably be considered that John Jackson made his latest investment on May 27, 1968, less than three years prior to the filing of this suit. John M. Jackson as trustee of the William H. Jackson Trust was an

It thus appears that as to some or all of the causes of action of some of the plaintiffs this suit was filed within the limitations period most often applied by the federal courts in similar actions even if there were no circumstances equitably extending the starting date of the limitations period.

Plaintiffs urge that the Court of Appeals, after reviewing the authorities, precisely distilled the limitations rule that should apply here and that it could not be better stated than in that Court's opinion. Quoting from its opinion in *Hochfelder* v. *Midwest Stock Exchange*, 503 F. 2d 364 (7th Cir.) *cert. denied* 419 U.S. 875, 42 L.Ed 2d 114, (1974) the Court said:

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[1] (Continued)
escrow investor. John M. Jackson individually also was an escrow investor. On May 27, 1968, to provide funds for the trust beneficiaries John Jackson personally paid $5,000 to himself as trustee and notified Nay to transfer $5,000 of the Trust escrow investment from the trust escrow investment to his personal escrow investment. When he did this on May 29, 1968, his personal investment in the escrow fund increased by $5,000. This transaction was the equivalent of his sending an additional $5,000 to Nay and having Nay send $5,000 to the trustee, in which case it would be clear that Mr. Jackson made an additional investment on May 27, 1968. (Supplemental Answers to Interrogatories filed August 2, 1972. Jackson answer to #39)

In respect to the last investment dates Ernst & Ernst state that the last 'escrow' investment of many of the Respondents was made in years prior to the 1967 audit year but does not state this as to all of the plaintiffs. The Court of Appeals in its opinion stated that the last of the escrow transactions consummated in 1966. E. & E. Pet. for Cert. App. 2a. This inadvertence probably resulted from a statement in Ernst & Ernst brief to the Court of Appeals that "all plaintiffs had invested in the escrow by 1966". Ernst & Ernst brief, Court of Appeals, 35.

> Often the underlying fraud, carefully concealed in and of itself, would cloak the implementing actions of others. Accordingly, where the acts of a defendant facilitate the perpetration of a concealed fraud of another, the bar of the statute of limitations should not begin to run until a plaintiff obtains knowledge or through due diligence should have obtained knowledge of the underlying fraud.

The Court then concluded with the statement:

> In our judgment plaintiffs may avail themselves of the equitable tolling doctrine and the bar of the statute of limitations does not begin to run until it can otherwise be established that they knew or in the exercise of due diligence should have known of N..y's fraud. Whether plaintiffs knew or in the exercise of due diligence should have known of Nay's fraud is, on the basis of the evidence before us, an issue properly to be decided at a trial.

CONCLUSION

For the foregoing reasons, the judgment of the Court of Appeals should be affirmed and this case remanded to the District Court for further proceedings.

Respectfully submitted,

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